TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 303

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

AMERICAN DENTAL CO.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITION FOR CERTIORARI FILED AUGUST 14, 1942
CERTIORARI GRANTED OCTOBER 12, 1942

In the
United States Circuit Court of Appeals
For the Seventh Circuit

No. 7847

AMERICAN DENTAL COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Review of Decision of the United States Board of Tax Appeals.

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STATEMENT OF EVIDENCE.

Petitioner's Witnesses.

Respondent's Witness.

PROCEEDINGS IN U. S. CIRCUIT COURT OF APPEALS

1 American Dental Company,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket No. 102977.

Appearances:

For Taxpayer: Wm. E. Hughes, Esq.
For Comm'r: Jonas M. Smith, Esq.

DOCKET ENTRIES.

1940

May 27—Petition received and filed. Taxpayer notified. (Fee paid.)

May 27—Copy of petition served on General Counsel.

July 19—Answer filed by General Counsel.

July 19—Request for hearing in Chicago, Ill., filed by General Counsel.

July 23—Notice issued placing proceeding on Chicago, Ill., Calendar. Answer and request served.

Oct. 8—Hearing set Dec. 2, 1940 in Chicago, Ill.

Dec. 2—Hearing had before Mr. Murdock on motion of petitioner to file amended petition, granted. Amended petition filed. Copy served. Application for subpoena filed.

Dec. 2—Subpoena duces tecum to Mallers Bldg. Trust, issued.

Dec. 2—Subpoena duces tecum to American Dental Co., issued.

Dec. 4—Hearing had before Mr. Murdock on merits. Submitted. Answer to amended petition filed, copy served. Briefs due as per rules.

Dec. 11—Transcript of hearing 12/4/40 filed.

1941

Jan. 16—Brief filed by taxpayer.

Jan. 18—Brief filed by General Counsel.

Apr. 3—Motion to amend brief filed by taxpayer. 4/3/41 granted.

Apr. 16—Copy of brief served on General Counsel.

May 7—Findings of fact and opinion rendered, Murdock, Div. 3. Decision will be entered for the respondent. 5/7/41 copy served.

May 7—Decision entered, Murdock, Div. 3.

June 2—Motion for rehearing and in the event of its denial for review by the Full Board filed by taxpayer.

June 3—Order denying review by the Board but the motion insofar as it asks for a rehearing is referred to Div. 3 (Murdock) for action, entered.

June 6—Order that motion of petition insofar as it asks for rehearing is denied, entered.

Aug. 14—Petition for review by United States Circuit Court of Appeals, 7th Circuit, and statement of points filed by taxpayer.

Aug. 14—Praecipe for record filed by taxpayer—with proof of service thereon.

2 Aug. 16—Proof of service of petition for review and statement of points filed.

Aug. 29—Agreed statement of evidence filed.

Sept. 22—Motion for 30 day extension to prepare and transmit record filed by taxpayer.

Sept. 23—Order enlarging time to Nov. 12, 1941 to prepart and transmit the record, entered.

Sept. 29—Copies of statement of evidence (agreed) filed 8/29/41 received.

Filed May 27, 1940.

3 UNITED STATES BOARD OF TAX APPEALS.

American Dental Company,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket No. 102977.

PETITION.

Filed May 27, 1940.

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (SN-IT-3) dated May 21, 1940, and as a basis of its proceeding alleges as follows:

(1) The petitioner is a corporation with its principal office at 5 South Wabash Avenue, Chicago, Illinois. The return for the period here involved was filed with the collector for the First district of Illinois.

(2) The notice of deficiency (a copy of which is attached

and marked Exhibit A) was mailed to the petitioner on May 21, 1940.

(3) The taxes in controversy are income and profits taxes for the calendar year 1937 and in the amount of $6744.08.

4 (4) The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) Respondent erred in adding to petitioner's 1937 income the sum of $19,234.21 for an alleged "cancellation of indebtedness."

(5) The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner denies that the said sum of $19,234.21 constituted indebtedness due from petitioner to others. The alleged forgiven indebtedness consisted of interest which petitioner's bookkeeper by mistake charged on its books on open accounts due from petitioner to others. There was no agreement between petitioner and its debtors that interest should be paid on these accounts and petitioner was subsequently advised that it was not legally obligated to pay interest and so advised its debtors who took the same view. Hence petitioner denies that any indebtedness was cancelled because said interest was never legally due and owing. Petitioner received very little benefit (in comparison with the deficiency herein asserted) from the deduction of this interest because its losses in some of the years in which this interest was deducted were so large that had it not been deducted petitioner would have had no taxable income.

(b) However, petitioner asserts that if any indebtedness was cancelled such cancellation was without consideration and hence was a gift to petitioner and is expressly excluded from taxable income by the provisions of the Revenue Act expressly excluding gifts therefrom.

5 Wherefore, the petitioner prays that this Board may hear the proceeding and disallow the deficiency.

(signed) John E. Hughes,
Counsel for Petitioner,
First National Bank Bldg.,
Chicago, Illinois.

State of Illinois }
County of Cook } ss.

William H. Schroll being first duly sworn, deposes and says that he is the President of the petitioner above named and that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition or had the same read to him and is familiar with the statements contained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and that those he believes to be true.

(signed) Wm. H. Schroll.

Subscribed and Sworn to before me this 23 day of May, A. D. 1940.

(signed) Mabel Grant,
Notary Public.

(Notarial Seal)
Com. Exp. 8/28/42.

6 SN-IT-3

"EXHIBIT A".

TREASURY DEPARTMENT.

Internal Revenue Service.

Chicago, Illinois.

May 21, 1940.

Internal Revenue Agent in Charge
Chicago Division
Room 1100, 105 West Adams Street

American Dental Company,
5 So. Wabash Avenue,
Chicago, Illinois.

Sirs:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1937 discloses a deficiency of $6,339.77 and that the determination of your excess-profits tax liability for the year mentioned discloses a deficiency of $404.31 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiencies mentioned.

Within 90 days (not counting Sunday or a legal holiday in the District of Columbia as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiencies.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Internal Revenue Agent in Charge, Chicago, Illinois for the attention of SN:IT. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiencies, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,
Guy T. Helvering,
Commissioner,
By O. W. Olson,
Internal Revenue Agent.

Enclosures:
Statement.
Form of waiver.
Form 272M.
MA:ME

7

Statement.

SN:IT

American Dental Company,
5 So. Wabash Avenue,
Chicago, Illinois.

Tax liability for the Taxable Year Ended December 31, 1937.

	Liability	Assessed	Deficiency
Income Tax	$11,019.51	$ 4,679.74	$ 6,339.77
Excess-profits Tax	404.31	None	404.31
	$11,423.82	$ 4,679.74	$ 6,744.08

In making this determination of your income and excess-profits tax liability, careful consideration has been given to the report of examination dated January 31, 1939; to your protest dated April 27, 1939; and to the statements made

at the conferences held on May 16, 1939 and August 18, 1939.

If you do not acquiesce in all of the adjustments making up the deficiencies indicated, but desire to stop the accumulation of interest on that part of the deficiencies resulting from adjustments to which you agree, please fill out the enclosed form of waiver, inserting therein the amount of the deficiencies you desire to have assessed at once. The execution of the form for the agreed portion of the deficiencies will not deprive you of your right to petition the United States Board of Tax Appeals for a redetermination of the deficiencies.

Adjustments to Net Income.

Net income as disclosed by return			$18,292.39
Unallowable deductions and additional income			
(a)	Taxes	$ 177.85	
(b)	Interest expense	454.28	
(c)	Cancellation of indebtedness	19,234.21	19,866.34
Net income adjusted			$38,158.73

8 Explanation of Adjustments.

(a) Taxes, deducted in your return in the amount of $4,936.14, have been reduced to $4,758.29, the amount which accrued during the taxable year and deductible under the provisions of section 23(c) of the Revenue Act of 1936.

(b) Interest expense has been disallowed to the extent of $454.28, since this amount was forgiven prior to the end of the taxable year and included in the amount of $25,219.65 charged to notes and accounts payable and credited to surplus during the year.

(c) Income has been increased by the sum of $19,234.21, representing that part of the amount charged to accounts and notes payable and credited to surplus within the year, in accordance with an agreement reached with your creditors for the cancellation or reduction of your indebtedness, which consists of items deducted or otherwise taken into account in computing your net income for years prior to 1937 and for which you have received a tax benefit.

Computation of Tax.

Excess-Profits Tax:		
Taxable net income		$38,158.73
Less:		
10% of $314,201.91 value of capital stock as declared in your capital stock tax return for year ended June 30, 1937		31,420.19
Net income subject to excess-profits tax		$ 6,738.54
5% of declared value of capital stock		$15,710.10
Balance		$ None
Excess-profits tax:		
6% of $6,738.54		$ 404.31
Total excess-profits tax		$ 404.31
9 Excess-profits tax assessed:		
Original March 1938 list, account No. 403360		None
Deficiency of excess-profits tax		$ 404.31
Income Tax		
Normal Tax:		
Taxable net income		$38,158.73
Less:		
Excess-profits tax (accrued)		404.31
Net Income for normal tax computation		$37,754.42
Less:		
Interest on U. S. obligations		None
Normal tax net income		$37,754.42
8% of $ 2,000.00 (Over 0 to $ 2,000)		$ 160.00
11% of $13,000.00 (Over $ 2,000 to $15,000)		1,430.00
13% of $22,754.42 (Over $15,000 to $40,000)		2,958.07
Total normal tax		$ 4,548.07
Surtax on Undistributed Profits:		
Taxable net income		$38,158.73
Less:		
Excess-profits tax	$ 404.31	
Normal Tax	4,548.07	4,952.38
Adjusted net income		$33,206.35

Less:	
Dividends paid credit	None
Undistributed net income	$33,206.35
7% of $ 5,000.00	$ 350.00
12% of $ 3,320.64	398.48
17% of $ 6,641.27	1,129.02
22% of $ 6,641.27	1,461.08
27% of $11,603.17	3,132.86
Total surtax	$ 6,471.44
Normal tax	4,548.07
Total income tax (normal tax and surtax)	$11,019.51
Less:	
Foreign tax credit	None
Balance of tax assessable	$11,019.51
Income tax assessed (normal tax and surtax):	
Original March 1938 list, account No. 403360	4,679.74
Deficiency of income tax	$ 6,339.77

Filed July 19, 1940.

11 UNITED STATES BOARD OF TAX APPEALS.

* * (Caption—102977) * *

ANSWER TO PETITION.

Filed July 19, 1940.

Comes now the Commissioner of Internal Revenue by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed in the above-entitled cause, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the petition.

3. Admits the amounts in controversy are income and excess-profits taxes for the year 1937. Denies all other allegations contained in paragraph 3 of the petition.

4. Denies each and every allegation of error contained in paragraph 4 and its subdivision of the petition.

5 (a) and (b).. Denies the allegations contained in paragraph 5 and its subdivisions of the petition.

6. Denies generally and specifically each and every alle-

gation contained in the petition not hereinabove admitted, qualified or denied.

Wherefore it is prayed that the Board redetermine the correct amount of the deficiency involved in this pro-
12 ceeding to be equal to the amount determined by the Commissioner, viz., income tax for the taxable year ended December 31, 1937, $6,339.77; excess-profits tax for the taxable year ended December 31, 1937, $404.31.

(Signed) J. P. Wenchel,
FRS.

J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
F. R. Shearer,
Division Counsel.
Jonas M. Smith,
Special Attorney, Bureau of Internal Revenue.

13 UNITED STATES BOARD OF TAX APPEALS.

Filed Dec. 2, 1940.

• • (Caption—102977) • •

AMENDED PETITION.

Filed Dec. 2, 1940.

The above-named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (SN-IT-3) dated May 21, 1940, and as a basis of its proceedings alleges as follows:

(1) The petitioner is a corporation with its principal office at 5 South Wabash Avenue, Chicago, Illinois. The return for the period here involved was filed with the collector for the First district of Illinois.

(2) The notice of deficiency (a copy of which is attached and marked Exhibit A) was mailed to the petitioner on May 21, 1940.

(3) The taxes in controversy are income and profits taxes for the calendar year 1937 and in the amount of $6744.08.

14 (4) The determination of the tax set forth in the said notice of deficiency is based upon the following errors:

(a) Respondent erred in adding to petitioner's 1937 income the sum of $19,234.21 for an alleged "cancellation of indebtedness."

(5) The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) Petitioner alleges that if any interest on indebtedness was forgiven such forgiveness was necessarily a gift and as such is expressly exempt from income tax by the Revenue Act. A promise to pay a smaller sum in consideration of a release from liability to pay a larger sum is not an enforceable contract. In such a case a creditor may sue for the balance at any time. Unless the creditor has made a gift no indebtedness is or can be forgiven under such circumstances.

(b) Petitioner alleges that the sums of $16,427.81 and $519.85 of said $19,234.21 constituted interest on accounts due for merchandise. Petitioner never received any money at any time for said interest and was not enriched either by this interest or the rent mentioned herein except to the extent of such benefit as it secured by deducting this sum from its income tax returns in former years, the amount of such benefit being much smaller and grossly disproportionate to the amount of tax claimed from it herein. It has offered to pay respondent in settlement of this case the amount of tax saved it in former years by said deductions but respondent has refused this offer.

(c) Petitioner alleges its creditors agreed prior to 1937 it would not have to pay said interest.

(d) The balance of the alleged forgiveness constituted $7,798.99 rent. Petitioner owed its landlord $15,298.99 rent at the end of 1933. In December 1933, its landlord agreed that the landlord would accept $7,500 in full payment of said $15,298.99. Said $7,798.99 was forgiven prior to the year 1937 involved in this appeal.

(e) The fair market value of petitioner's assets did not equal the amount of its liabilities at the time in 1937 respondent claims said indebtedness was forgiven.

Wherefore, the petitioner prays that this Board may hear the proceeding and disallow the deficiency.

Wm. E. Hughes,
Counsel for Petitioner,
First National Bank Bldg.,
Chicago, Illinois.

State of Illinois, }
County of Cook. } ss.

William H. Schroll being first duly sworn, deposes and says that he is the President of the petitioner above named and that he is duly authorized to verify the foregoing petition; that he has read the foregoing petition or had the same read to him and is familiar with the statements
16 contained therein, and that the statements contained therein are true, except those stated to be upon information and belief, and that those he believes to be true.

William H. Schroll.

Subscribed And Sworn to before me this 2nd day of December, A. D. 1940.

Isaac M. Edson,
(Seal) *Notary Public.*

For Ex. "A", see Ex. "A" attached to Petition.

17 UNITED STATES BOARD OF TAX APPEALS.

* * (Caption—102977) * *

Filed Dec. 4, 1940.

ANSWER TO AMENDED PETITION.

Filed Dec. 4, 1940.

Comes now the Commissioner of Internal Revenue by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the amended petition filed in the above-entitled cause, admits and denies as follows:

1 and 2. Admits the allegations contained in paragraphs 1 and 2 of the amended petition.

3. Admits the amounts in controversy are income and excess-profits taxes for the year 1937. Denies all other allegations contained in paragraph 3 of the amended petition.

4. Denies each and every allegation of error contained in paragraph 4 and its subdivision of the amended petition.

5 (a). Denies the allegations contained in subparagraph (a) of paragraph 5 of the amended petition.

5 (b). Admits petitioner received benefit to the extent of $19,234.21 by deducting this sum from its income tax returns in former years. Denies all other allegations con-

tained in subparagraph (b) of paragraph 5 of the amended petition.

5 (c). Denies the allegations contained in subparagraph (c) of paragraph 5 of the amended petition.

18 5 (d). Admits $7,798.99 of the forgiveness constituted rent. Denies all other allegations contained in subparagraph (d) of paragraph 5 of the amended petition.

5 (e). Denies the allegations contained in subparagraph (e) of paragraph 5 of the amended petition.

6. Denies generally and specifically each and every allegation contained in the amended petition not hereinbefore admitted, qualified or denied.

Wherefore it is prayed that the Board redetermine the correct amount of the deficiency involved in this proceeding to be equal to the amount determined by the Commissioner, viz., income tax for the taxable year ended December 31, 1937, $6,339.77; excess-profits tax for the taxable year ended December 31, 1937, $404.31.

(Signed) J. P. Wenchel, D. A. I.
J. P. Wenchel,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
F. R. Shearer,
Division Counsel.
Jonas M. Smith,
Special Attorney, Bureau of Internal Revenue.

27 IN THE UNITED STATES CIRCUIT COURT OF APPEALS,

For the Seventh Circuit.

American Dental Company, *Petitioner,*
vs.
Commissioner of Internal Revenue, *Respondent.*
} B. T. A. Docket No. 102977.

STATEMENT OF THE EVIDENCE.

Filed Aug. 24, 1941.

WILLIAM H. SCHROLL, 830 Monroe Avenue, River Forest being duly sworn testified as follows:

I have been president of petitioner since it was organized in 1920. That is my sole business and has been since petitioner was organized. Petitioner is in the dental laboratory business. I am there approximately every business day and am thoroughly familiar with its affairs. I conducted the negotiations for the forgiveness of debt in issue here. The first conversation was in the office of the Mallers Building the 19th of December, 1933 when we were negotiating a new lease. John B. Mallers Jr., trustee and agent of the building and John Johansen, superintendent of the building were present.

Q. What did you say to him and the other parties you speak of, and what did they say?

A. I asked Mr. Mallers for an adjustment on the back rent, which we had been unable to pay, and which accumulated to an amount of over $15,000. "Well," he says,
28 "I will make an adjustment of this item." He said; "Go ahead, and sign up the new lease, and so forth, and I will give it a little thought and will let you hear from me."

Q. What was the next conversation, if any?

A. There was not anything more, I didn't hear anything more from him until April, and I went up to see what he had made up his mind to do; and he says, "Well," he says, "pay me $7,500, and I will call it square and forget the rest of it."

I said, "Well, I haven't $7,500."

"Well," he says, "You worry about raising the $7,500; get busy and raise it and pay it when you can, and forget the rest of it."

Q. Did you raise this $7,500 and pay it?

A. Yes, sir.

Q. When did you pay it?

A. We paid that in February, $2,500; in February, 1937, we paid $2,500; and in April of this same year, $2,500; and in June of the same year, $2,500.

Q. Did you have any conversation with him about the arjustment after that conversation in April of 1934?

A. No, I did not.

Q. With reference to those interest items which have been stipulated, did you conduct the negotiations for the reduction of those interest items?

A. I did.

Q. What conversation did you have with Julius Aderer, Incorporated, whom you owed $10,546.06?

29 A. I went to New York in November of 1936, and pointed out to Julius Aderer the fact that we were not able to charge interest on any of our outstanding accounts; and that we had found that very few, if any, of the other laboratories in the industry had paid interest on their past due accounts; and in view of the fact that we had always made our settlements on the 10th day of the month with notes on anything that we were unable to pay in cash, that I thought we were entitled to an adjustment on that item.

I asked him in the original—I asked at first for the cancellation of all interest that we had paid since the depression started. But it was finally agreed that the interest that was charged from January 1, 1932,—that is when we started losing money in our company, from then on—that the interest item was to be cancelled from then on in full. Julius Aderer told me that they would cancel the whole thing, to forget about it.

Q. Can you state exactly what he said, as nearly as you can?

A. Well, he was very much appreciative and said that they were appreciative of the business we had given him over the term of years, and said that we had been a good customer and he appreciated the business; and he said, "We will cancel the interest after January 1, 1932."

Q. What date was this that this was said, approximately?

A. It was the—it was on a Monday following the November election, so according to the calendar it must have been Monday, the 9th of November.

30 Q. You went down to New York?

A. Yes, sir.

Q. And this conversation was in his office in New York?

A. Yes, sir.

Q. And the year, the year was what year?

A. 1936.

Q. Now, all of this interest which was due was interest on notes which you had given in payment of merchandise?

A. That is right.

Q. What about C. L. Frame, to whom $5,314.81 was due according to the stipulation? Where was their office?

A. Their office is here in Chicago, 25 East Washington Street.

Q. Who did you see there, and when?

A. Immediately after my return I called on C. L. Frame Dental Supply Company and talked with Clare Frame and Irving Spangler. Frame is the president and Spangler is an officer of the company. I don't know whether he is vice president or what it is.

Q. And what was said by you and Clare Frame?

A. I pointed out to him that Mallers had made an adjustment of the rent item and that Aderer had agreed to cancel all the interest since the 1st of January, 1932; and they agreed to cancel interest the same.

Q. What did they say? State what they said and what you said.

31 A. Clare Frame said that we will cancel our interest on January 1, 1932.

Q. What date, approximately, did this conversation occur?

A. Well, it must have been along about the—I did not stay long in New York at that time; I got what I went after the first day; and I would dare say it must have been about the 11th or 12th of November in 1936.

Q. It was some time in that month?

A. It was right during that week.

Q. What about this Goldsmith Brothers' item of $1,086.87, mentioned in the stipulation? Where is their office?

A. Their office is at 58 East Washington Street.
Q. Chicago?
A. Yes.
Q. When did you go over there?
A. I left Frame's office and went directly over to Goldsmith's office and talked to Mark Goldsmith, vice president and general manager of the company, and Mr. Adelsdorf.
Q. What was said by you?
A. I stated to them that Mallers had made the adjustment: That Aderer had cancelled or had agreed to cancel the interest; and Frame told me they would cancel the interest. Mark Goldsmith said, "All right, we will cancel the interest from January 1, 1932."
Q. Now, this interest which you owed Frame and Goldsmith was also interest on notes given for merchandise purchased?
A. Yes, sir.

32 *Cross-Examination.*

Q. If I understand your testimony on direct examination, you first approached the Mallers Building Company with reference to forgiving the rent in 1933?
A. That is right.
Q. And you came to an agreement some time in 1934?
A. That is right.
Q. But the deal was not consummated until 1937, was it?
A. The deal was consummated in 1934, and the amount was fixed. In 1934 he said, "Well, pay it when you get it."
Q. But he did not say he would forgive the amount of the rent due until you paid the $7,500, did he?
A. Oh, yes, he did.
Q. You paid him the $7,500, I believe you said, in February, April and June, 1937?
A. That is right.
Q. And then after you paid him, it was at that time, was it not, that you finally felt that the amount had been forgiven?
A. No, I thought the amount was forgiven, considered it forgiven in 1933. In fact, he proposed earlier in the year that all creditors cut our indebtedness 50 percent. He called me to his office in April, 1933, and wanted me to join him in a fight to ask all creditors for a 50 percent cut of our indebtedness.

We did not enter the forgiveness on our books in 1933. I suppose it was entered in 1937. I didn't pay any attention to the way it was entered on our books or anything like that. We were losing money right along there every year, had not been making any money.

33 At this point the income tax returns of petitioner for 1933 to 1937 inclusive were admitted in evidence as RESPONDENT'S EXHIBITS A to E inclusive.

The Witness: I had the conversation with Frame and Aderer in 1936. I recollect it was the Monday following the election in 1936. He said: "We will cancel the interest from January 1, 1932." From that time I understood no further interest was to be credited to the principal account. As to the interest tax returns for 1936 showing the deduction of interest on these accounts will say I didn't pay very much attention to these income tax reports. I admit I signed them but they were made up by our bookkeeper, a Mr. Davis. I don't know why it was deducted when I knew it was going to be cancelled. It is part of the amount that is in the final forgiveness.

The $25,219.65 we are talking about was deducted on our 1937 return. That is the first time it was entered on our books. That was the first time anyone inspecting our books could find out the indebtedness was forgiven. Of course I am not familiar with the way it was set up on our books.

Q. And these creditors wanted you to pay, what they wanted was to put you in position so that you could pay the balance, in better position to pay the balance?

A. Well, they hadn't so stated, but I would take it that they would, we had been good customers for many, many years.

Q. That is the reason they were willing to forego this interest they had already charged you, isn't that it?

A. I don't necessarily think so. They found they had been charging us interest when they had not been charging other customers interest.

34 Mr. Smith: No further questions.

Redirect Examination.

I did not make the tax returns or keep the books for 1936 and 1937.

HARRY L. DAVIS of 1037 Division Street, Oak Park, a witness for petitioner, being duly sworn, testified as follows:

I am treasurer of the American Dental Company and have been since 1920. The income tax returns for the year 1936 were made under my supervision. I didn't make them out. The books are under my supervision also. I did not participate in the negotiations for the forgiveness of this indebtedness and was not present at them.

Cross-Examination.

I am familiar with how this matter was handled in the books of the company. The books are all here. The entry of the Aderer forgiveness was made December 22, 1937. It was $10,546.06. It was charged against the amount that was owed the Aderer Company on December 1 there was a balance of $36,039.96 and after this entry it was $25,493.90. Prior to the entry reducing Frame's account we owed $14,832.23 and at the time of the entry we owed him $10,594.30. That was the amount that was entered in the tax return for 1937. We owed Goldsmith $3,566.10 and afterwards we owed $2,950.16. That also went into the forgiveness of indebtedness for the 1937 return. Prior to making the entry with reference to the Maller's rent our books show we owed them $15,298.99. We made an entry February 26, 1937, of $25,000; on April 23, 1937, of $2500 and on June 25, 1937 of $2500. These three payments were paid by check. The next entry is February 27th forgiveness item, $7,798.99. On that basis we owed them nothing, our indebtedness was cleared up.

Redirect Examination.

When I said our indebtedness was paid up I speak of the amount as shown by the books and solely of that.

In explanation of why I made these entries at this time will say in 1934, I knew there was some arrangement made for cancellation of some of the old balance that we owed but did not know the amount. I did not know that amount until April, 1934. Well, I never gave any consideration or thought to its being a taxable item; and for that reason

I didn't make any entries on the account at all until we had paid these different items, and those entries were not made until the end of 1937. I never considered it would be considered income.

Recross Examination.

I didn't know about the arrangement with reference to the $7500 until April, 1934. I knew there was a settlement made on that basis then. The balance was not entered on the books as forgiveness of indebtedness until several months after the payments were made in 1937, when we closed our books for 1937.

Mr. Hughes: There is one more thing I forgot. Will you stipulate that the petitioner offered to pay the Government in settlement of this amount of taxes, the amount stated by these deductions in prior years?

36 Mr. Smith: If your Honor please, I don't see any pertinency to any such request for such a stipulation.

Mr. Hughes: Subject to the objection—

Mr. Smith: I object to the whole matter, I don't think it is pertinent. The whole matter should be stricken out, what he offered to pay the Government.

The Court: He simply asks you, as I understand it, if it is not a fact that they agreed to do that; but it does not preclude you from objecting to it; but simply that it is a fact.

Mr. Smith: Yes, Mr. Hughes wrote a letter, and he said in that letter—I will read what he says, the last paragraph. The letter is dated November 20, 1940, and is addressed to Mr. Shearer, 1300 Board of Trade Building, Chicago, Illinois, attention of Mr. Jonas M. Smith. The last paragraph reads as follows: "As you know, I offered to settle the case by having my client pay the amount of tax which it is claimed my client saved by the deductions."

The Court: You object to that?

Mr. Smith: I object to that on the ground that it is not pertinent to the issue here at all.

The Court: The record may show the fact. Whether it is pertinent or not is to be argued. The petitioner rests, is that right?

37 MABEL GRANT, a witness for respondent, being duly sworn, testified as follows:

I am the bookkeeper for the Mallers Building Trust. I made the entries in the books which I have here. On January 1, 1937 the books show the American Dental Company owed $15,306.34.

Q. May I ask you, that was the amount of rental that was to be paid under the lease that you now have, is that right?

A. Well, when we carry an old balance, and we receive money, we always apply it on the old balance, on account of the statute of limitations.

Q. In other words, you applied these on the balance that was due back for prior years?

A. Well, that was the assumption.

Q. That was the assumption?

A. Yes, sir.

Q. Now, then, under your method you made entries against that old balance, is that right?

A. It does not show that way; they are just posted.

I have an entry showing an item of $7,798.99. I have a posting in March, 1937. I show it in the Journal, page 691, and we credited the American Dental Company with $7,798.99 and charged that to bad and doubtful accounts "to write off the balance of old account as per agreement."

Cross-Examination.

On January 1, 1934 the sum of $15,647.89 was owing by the American Dental Co. to Mallers Trust according to its books. All the money which we collected between 1934 and January, 1937, was applied against that account.

38 A new lease was made effective January 1, 1934 which reduced the rent to $8,000 per year. The $8,000 was paid in 1934. The same is true for 1935 and 1936.

Mr. Hughes: In other words, what I am trying to get at is this, and I will rephrase it this way.

Q. (By Mr. Hughes.) According to your way of applying payments to the oldest accounts on your books—you testified the American Dental Company owed $15,000 back rent in January, 1934; also in 1934 and 1935 you took in from them about $16,000. Now, under your system of

applying payments to the oldest accounts, by the end of 1935 this old balance of $15,000, which was existing on January 1, 1934, was wiped out so far as your books are concerned?

A. It would amount to the same thing.

I do not know what the negotiations were for the adjustment of the rent. I was not present. It was Mr. Mallers and Mr. Johansen. Mr. Johansen is in the office now. Mr. Mallers died in July, 1934. These negotiations were made before then.

Redirect Examination.

The effect of making the entry of $7,798.99 was to wipe out the balance due.

Recross Examination.

This is the first time the Mallers Trust has been in the black for six years.

Respondent's exhibit E, being the petitioner's Income Tax Return for 1937, is annexed hereto.

39 The foregoing is all of the material evidence deduced at the hearing of the Board of Tax Appeals and the same is approved by the undersigned as attorneys for petitioner and respondent in review.

(S) John E. Hughes
John E. Hughes
Attorney for petitioner in review.

(S) J. P. Wenchel
J. P. Wenchel
Attorney for Respondent in review.

23—

1937 UNITED STATES CORPORATION INCOME AND EXCESS-PROFITS TAX RETURN 1937

Treasury Department — [illegible]

For Calendar Year 1937 or Fiscal Year

beginning ...., 1937, and ended ...., 1938

No.	33
[illegible]	403360
[illegible]	2

AMERICAN DENTAL COMPANY
(Name)

5 South Wabash Avenue
(Street and number)

Chicago — Cook — Illinois
(Post office) (County) (State)

Kind of business: Mechanical Dentistry

× 0○

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EXCESS-PROFITS TAX COMPUTATION

Item No.				Rate	Amount of Tax
1. Net income for excess-profits computation (item 20, Schedule A)		$ 18,292	39		
2. State value of capital stock declared in your capital stock tax return for the year ended June 30, 1937 ...	31,201.91				
3. Enter here 10 percent of item 2	$ 31,120 19				
4. Dividends received credit (85 percent of Schedule F, column 2)	None	31,120	19		
5. Balance subject to excess-profits tax (item 1 minus items 3 and 4)		$ None			
6. Amount taxable at 6 percent (5 percent of item 2, but not more than item 5)				6%	$
7. Balance taxable at 12 percent (item 5 minus item 6)				12%	
8. Total excess-profits tax					$ None

NORMAL TAX COMPUTATION

				Rate	
9. Net income for income tax computation (item 21, Schedule A)		$ 18,292	39		
10. Dividends received credit (85 percent of Schedule F, column 2)	$ None				
11. [illegible]					
12. Balance subject to normal tax (item 9 minus item 10 or 11)		18,292	39		
13. Tax on portion of item 12 not in excess of $2,000		$		8%	$ 160 00
14. Tax on portion of item 12 in excess of $2,000 and not in excess of $15,000				11%	1,430 00
15. Tax on portion of item 12 in excess of $15,000 and not in excess of $40,000				13%	428 01
16. Tax on portion of item 12 in excess of $40,000				15%	
17. Total normal tax in items 13 to 16					$ 2,018 01
Normal Tax on Corporations Not Subject to Graduated Normal Tax Rates (to be used in lieu of the normal tax rates above)					
18. Banks and trust companies (see Instruction II)		$		15%	$
19. Insurance companies				15%	
20. Corporations entitled to the benefits of section 251 of the Revenue Act of 1936				15%	
21. Corporations organized under the China Trade Act, 1922				15%	
22. Foreign corporations engaged in trade or business within the United States or having an office or place of business therein				22%	

UNDISTRIBUTED PROFITS SURTAX COMPUTATION

(See Instruction III regarding corporations exempt from surtax)

				Rate	
23. Net income for income tax computation (item 21, Schedule A)		$ 18,292	39		
24. Normal tax (item 17 above)	$ 2,018 01				
25. Credit for holding company affiliate or national mortgage association (see Instruction III (b) and (c))		2,018	01		
26. Adjusted net income (item 23 minus items 24 and 25)		$ 16,274	38		
27. Dividends paid credit (line 13, Schedule M)	$ None				
28. Credit for contracts restricting dividend payments (see Instr. III)					
29. Undistributed net income (item 26 minus items 27 and 28)		$ 16,274	38		
30. Portion of item 29 taxable at 7%: $5,000 or 10% of item 26, whichever is greater (but not more than item 29)		$ 5,000	00	7%	$ 350 00
31. Portion of item 29 taxable at 12%: 10% of item 26 (but not more than item 29 minus item 30)		1,627	44	12%	195 29
32. Portion of item 29 taxable at 17%: 20% of item 26 (but not more than item 29 minus items 30 and 31)		3,254	88	17%	553 33
33. Portion of item 29 taxable at 22%: 20% of item 26 (but not more than item 29 minus items 30 to 32)		3,254	88	22%	716 07
34. Portion of item 29 taxable at 27%: (item 29 minus items 30 to 33)		3,137	18	27%	847 04
35. Total surtax in items 30 to 34					$ 2,661 73
36. Total normal tax and surtax (item 17 plus item 35 [illegible] item 18, 19, 20, 21, or 22)					4,679 74
37. Less: Credit for income taxes paid to a foreign country or United States possession allowed a domestic corporation (see Instruction IV)					
38. Balance of tax (item 36 minus item 37)					$ 4,679 74
39. Excess-profits tax (item 8 above)					
Total tax (item 38 plus item 39)					$ 4,679 74

Note: One form marked "DUPLICATE COPY" must be filed with this original return ($10 will be assessed if duplicate is not filed).

Schedule A.—NET INCOME COMPUTATION

GROSS INCOME

Item and Instruction No.			
1. Gross sales (where inventories are an income-determining factor) ... $[illegible] Less returns and allowances ... $ 3,523.66	$ 320,513 93		
2. Less cost of goods sold (from Schedule D-1)	196,282 81		
3. Gross profit from sales (item 1 minus item 2)	$ 124,231 12		
4. Gross receipts (where inventories are not an income-determining factor) $			
5. Less cost of operations (from Schedule D-2)			
6. Gross profit where inventories are not an income-determining factor (item 4 minus 5)			
7. Interest on loans, notes, mortgages, bonds, bank deposits, etc			
8. Interest on obligations of the United States (from Schedule B, line 19 (or 18))			
9. Rents			
10. Royalties			
11. Capital gain or loss (from Schedule E). (If a net loss, do not enter over $2,000)			
12. Dividends (from Schedule F)			
13. Other income (state nature of income)			
14. Total income in items 3, and 6 to 13, inclusive	124,231 12	$ 124,231 12	

DEDUCTIONS

15. Compensation of officers (from Schedule G)	$ 28,816 60		
16. Salaries and wages (not deducted elsewhere) See schedule	22,921 23		
17. Rent	10,310 61		
18. Repairs			
19. Bad debts (from Schedule H)	4,007 79		
20. Interest	506 60		
21. Taxes (from Schedule I) (Do not include Federal excess-profits tax)	4,936 14		
22. Contributions or gifts (from Schedule J)			
23. Losses by fire, storm, etc. (Submit schedule, see Instruction 23)			
24. Depreciation (from Schedule K)	1,744 12		
25. Depletion of mines, oil and gas wells, timber, etc. (Submit schedule, see Instruction 25)			
26. Other deductions authorized by law (from Schedule L)	3[illegible],495 66		
27. Total deductions in items 15 to 26, inclusive		105,938 73	
28. Net income for excess-profits tax computation (item 14 minus item 27)		$ 18,292 39	
29. Less: Federal excess-profits tax (see Instruction 29)	$		
30. Interest on obligations of United States (item 8, above)			
31. Net income for income-tax computation (item 28 minus items 29 and 30)		$ 18,292 39	

Schedule M.—RECONCILIATION OF NET INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS

1. Total [illegible] dividends charged to [illegible] during the taxable year	$	17. Earned surplus and undivided profits as shown by balance sheet at close of preceding taxable year (Schedule N)	$ 150,114 76
[illegible] or gifts in excess over 5 percent [illegible]		18. Net income for income tax computation (item 31, Schedule A)	18,292 39
[illegible] income taxes 1937	4,679 7[illegible]	19. Nontaxable and partially exempt income:	
[illegible] taxes of United States possessions or [illegible] countries if claimed as a credit in whole or in part in item 37, page 1 of return		(a) Interest on:	
5. Federal taxes paid on tax-free covenant bonds		(1) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	
6. Special improvement taxes tending to increase the value of the property assessed		(2) Obligations of United States issued on or before September 1, 1917, Treasury Notes, Treasury Bills, and Treasury Certificates of Indebtedness	
7. Replacements, renewals and capital expenditures charged to expense on the books		(3) United States Savings Bonds and Treasury Bonds owned in the principal amount of $5,000 or less	
8. Insurance premiums paid on the life of an officer or employee where the corporation is directly or indirectly a beneficiary		(4) United States Savings Bonds and Treasury Bonds owned in the principal amount of over $5,000	
9. Nondeductible interest incurred to purchase or carry exempt interest obligations		(5) Obligations of instrumentalities of the United States	
10. Excess of capital loss, if any, over amount allowable as a deduction in item 11, Schedule A		(b) Other nontaxable income (itemize):	
11. Additions to surplus reserves (itemize each reserve separately):		(1)	
(a)		(2)	
(b)		(3)	
(c)		(4)	
(d)		20. Charges against surplus reserves deducted from income in the return (itemize):	
12. Other unallowable deductions:		(a)	
(a)		(b)	
(b) Additional 1935 Income tax	22 5[illegible]	(c)	
(c)		21. Adjustments for tax purposes not recorded on books (itemize):	
(d)		(a)	
13. Adjustments for tax purposes not recorded on books (itemize):		(b)	
(a)		(c)	
(b)		22. Sundry credits to earned surplus (itemize):	
(c)		(a) To adjust income tax	
14. Sundry debits to earned surplus (itemize):		(b) reserve account	1 10
(a)		(c) Forgiveness of debts	25,219 65
(b)		(d)	
(c)			
(d)			
15. Earned surplus and undivided profits as shown by balance sheet at close of the taxable year (Schedule N)	188,914 62		
16. Total of lines 1 to 15	$ 193,627 90	23. Total of lines 17 to 22	$ 193,627 90

NOTE.—Attach to this return and mark as Schedule M-1, M-2, etc., analyses of surplus reserves, if any, as shown by the balance sheets (Schedule N), additions to which are not deductible for income and excess-profits tax purposes.

Schedule C—[illegible]

1. [illegible] (a) (b) (c) (d)	$	
2. [illegible]		
3. Total	$	
4. [illegible]	$	
5. [illegible] (a) (b) (c) (d)		
6. Total	$	

Schedule C-2—COST OF GOODS SOLD (See Instruction [illegible])

1. Inventory at beginning of year	$ 6,934	11
2. [illegible]	103,713	16
3. Salaries and wages	95,694	47
4. Other costs per books		
5. Total	$ [illegible]	[illegible]
6. Less inventory at end of year	8,140	93
7. Cost of goods [illegible]	$ [illegible]	[illegible]

Schedule C-3—[illegible]

1. Salaries and wages	$	
2. Other costs (a) (b) (c) (d) (e)		
3. Total [illegible]	$	

Schedule E—CAPITAL GAINS AND LOSSES [illegible]

1. [illegible]	2. [illegible]	3. [illegible]	4. [illegible]	5. [illegible]	6. [illegible]	7. [illegible]
NONE		$	$	$	$	$

Total [illegible] $

[illegible]

Schedule F—[illegible]

1. [illegible]	2. [illegible]	3. [illegible]	4. [illegible]
NONE	$	$	$
Totals	$	$	$

Total of columns 2, 3, and 4 [illegible] $

[illegible]

Schedule G—COMPENSATION OF OFFICERS (See Instruction 18)

1. [illegible]	2. [illegible]	3. [illegible]	4. [illegible]	5. [illegible]	6. [illegible]	
H. H. Schrull	President	Entire	53%	6%	$ 10,250	00
J. A. Sarson	Vice President	Entire	3%	5%	4,200	00
C. S. Lange	Secretary	Entire	6%	4%	6,833	30
H. L. Davis	Treasurer	Entire	29%	0	6,833	30

Total Compensation of Officers [illegible] $ 28,816 60

Note.—[illegible]

Schedule H—BAD DEBTS [illegible]

1. [illegible]	2. [illegible]	3. [illegible]	4. [illegible]	5. [illegible]	6. [illegible]
[illegible]	$	$	$	$	$
See attached schedule					

Note.—[illegible]

E.3

Schedule I.—TAXES (See Instruction 22)

Nature	Amount	Nature	Amount
Illinois Franchise	$ 90.25	Social Security Title 8	$ 1,196.34
Delaware Franchise	150.06		
Capital Stock Tax	314.00		
Personal Property estimate	284.77		
Social Security Title 9	2,920.45		
	$	Total (enter as Item 21, Schedule A)	$ 4,926.14

Schedule J.—CONTRIBUTIONS OR GIFTS (See Instruction 23)

Name and Address of Organization	Amount	Name and Address of Organization	Amount
	$		$

Total (enter as Item 23, Schedule A, subject to 5 percent limitation per Instruction 23) $

Schedule K.—DEPRECIATION (See Instruction 24)

1. Kind of Property	2. Date Acquired	3. Cost or Other Basis	4. Assets Fully Depreciated in Use at End of Year	5. Depreciation Allowed in Prior Years	6. Remaining Cost to Be Recovered	7. Life Used in Accumulating Depreciation	8. Estimated Remaining Life	9. Depreciation Allowable This Year
		$	$	$	$			$

See attached schedule

Total (enter as Item 24, Schedule A) $

Schedule L.—OTHER DEDUCTIONS (See Instruction 28)

See attached schedule

Schedule M.—DISTRIBUTIONS TO STOCKHOLDERS AND DIVIDENDS PAID CREDIT (See Instruction 33)

Distributions Out of Earnings or Profits of the Taxable Year or Out of Earnings or Profits Accumulated Since February 28, 1913 (Dividends paid)	1. Taxable Distributions	2. Nontaxable Distributions
1. Cash	$	
2. Assets other than cash or the corporation's own securities. (See notes 1 and 5.) (Indicate nature of assets.)		
3. Treasury stock. (See notes 1 and 5)		
4. Obligations of the corporation (bonds, notes, scrip, etc.). (See notes 2 and 5)		$
5. Common stock of the corporation distributed to holders of common stock. (See notes 2 and 5)		$
6. Preferred stock of the corporation distributed to holders of common stock. (See notes 2, 4, and 5)	$	
7. Common stock of the corporation distributed to holders of preferred stock. (See notes 2, 4, and 5)		
8. Preferred stock of the corporation distributed to holders of preferred stock. (See notes 2, 4, and 5)		
9. Optional—Medium of payment elected by stockholders: (a) Cash		
(b) Common stock. (See notes 2 and 5)		
(c) Other. (See note 5.) (Specify nature)		
10. Totals of items 1 to 9	$	$

DIVIDENDS PAID CREDIT

11. Taxable distributions (line 10, column 1)	$
12. Dividend carry-over from preceding taxable year (attach schedule of computation)	
13. Dividends paid credit (total of lines 11 and 12). (Enter as Item 27, page 1)	$
14. Adjusted net income (item 26, page 1)	
15. Dividend carry-over (line 13 minus line 14)	$

RECONCILIATION

16. Total distributions out of earnings or profits of the taxable year or out of earnings or profits accumulated since February 28, 1913 (total of columns 1 and 2, line 10)	$
17. Total distributions charged to earned surplus and undivided profits, as shown on line 1, Schedule B	
18. Total distributions during the taxable year regardless of source	

In case the amounts entered on lines 16, 17, and 18 are not the same, explain difference.

Notes:

1. Enter the lesser of the two following amounts determined as of time of distribution: (a) The adjusted basis in the hands of the corporation as provided in section 113 of the Revenue Act of 1936, as amended; or (b) the fair market value.
2. Enter the amount of the fair market value at time of distribution.
3. Enter the lesser of the two following amounts determined as of the time of distribution: (a) Face value; or (b) fair market value.
4. Preferred stock for this purpose should be considered as stock which is preferred as to either dividends or assets, irrespective of formal designation.
5. Distributions in the form of rights to purchase assets or subscribe to stock or other obligations of the corporation should be entered in the lines applicable to the assets, stocks or other obligations for which rights were distributed.

Schedule M.—BALANCE SHEETS (See Instruction 7)

	Beginning of Taxable Year				End of Taxable Year			
	Amount		Total		Amount		Total	
ASSETS								
1. Cash			$ 13,124	79			$ 666	21
2. Notes receivable	$ 23,385	67			$ 19,341	57		
3. Accounts receivable	94,142	89			104,112	33		
(a) Total of lines 2 and 3	$ 117,528	76			$ 123,474	13		
(b) Less reserve for bad debts	3,362	70	114,166	06	4,650	38	118,823	74
4. Inventories								
(a) Raw materials	$ 6,187	01			$ 7,937	51		
(b) Work in process								
(c) Finished goods								
(d) Supplies	647	10			911	42		
			6,834	11			8,848	93
5. Investments (Government obligations):								
(a) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions	$				$			
(b) Obligations of the United States								
(c) Obligations of instrumentalities of the United States								
6. Other investments:								
(a) Stocks of domestic corporations	$				$			
(b) Bonds of domestic corporations								
(c) Stocks and bonds of foreign corporations								
(d) Treasury stock								
(e) All other investments or loans								
7. Deferred charges								
(a) Prepaid insurance, taxes, etc.			3,562	48			3,587	06
8. Capital assets:								
(a) Buildings	$				$			
(b) Machinery and equipment Fixtures	45,724	30			45,286	14		
(c) Furniture and fixtures								
(d) Delivery equipment								
(e) Other depreciable assets Auto	510	00			680	00		
(f) Total of lines (c) to (e)	$ 46,234	30			$ 45,970	14		
(g) Less reserve for depreciation	34,144	81	12,089	49	35,913	93	13,060	21
(h) Depletable assets	$				$			
(i) Less reserve for depletion								
(j) Land								
9. Other assets (Itemize below):								
Due from closed banks	$ 13	29			$			
Goodwill	270,268	26			270,268	26		
			270,281	55			270,268	26
10. Total Assets			$ 422,060	48			$ 415,236	41
LIABILITIES AND CAPITAL								
11. Accounts payable			$ 25,703	27			$ 3,677	24
12. Bonds, notes, and mortgages payable (with original maturity of less than 1 year)			60,051	13			39,438	36
13. Bonds, notes, and mortgages payable (with original maturity of 1 year or more)								
14. Accrued expenses:								
(a) Interest	$ 200	57			$			
(b) Taxes	4,928	82			8,264	86		
(c) All others			5,129	39			8,464	86
15. Other liabilities (Itemize below):								
	$				$			
16. Surplus reserves (Itemize below):								
	$				$			
17. Capital stock:								
(a) Preferred stock	$ 60,200	00			$ 58,900	00		
(b) Common stock	115,861	93	176,061	93	115,861	93	174,761	93
18. Paid-in or capital surplus								
19. Earned surplus and undivided profits			150,114	76			188,214	96
20. Total Liabilities and Capital			$ 422,060	48			$ 415,536	41

Schedule O.—CHANGES IN CORPORATION'S OBLIGATIONS AND CAPITAL STOCK (See Instruction 6)

	Obligations	Preferred Stock*	Common stock
1. Total cash receipts during taxable year from sale of corporation's own interest-bearing obligations with original maturity of 1 year or more and capital stock	$	$	$
2. Total cash expenditures during taxable year for purchase or retirement of corporation's own interest-bearing obligations with original maturity of 1 year or more and capital stock		$ 1,300 00	
3. Difference between lines 1 and 2	$	$ 1,300 00	$

* Preferred stock for this purpose should be considered as stock which is preferred as to other dividends or assets, irrespective of formal designation.

Schedule P—NATURE OF BUSINESS

Check the box to indicate the industry in which the corporation's main income-producing business falls

[illegible]

QUESTIONS

1. Date of incorporation .... January 9, 1920
2. State or country .... Delaware
3. State collector's office where your return for the preceding year was filed .... Illinois
4. The corporation's books are in care of .... H. L. Davis, Treas., Located at .... 5 W. Wabash Ave., Chicago, Ill.
5. Is the corporation a personal holding company within the meaning of section 351 of the Revenue Act of 1936, as amended by the Revenue Act of 1937? .... No .... If so, an additional return on Form 1120H must be filed.
6. Is this a consolidated return of railroad corporations? .... No .... If so, procure from the collector of internal revenue for your district Form 851, Affiliations Schedule, which shall be filled in, sworn to, and filed as a part of this return.
7. If this is not a consolidated return of railroad corporations, and (a) you owned at any time during the taxable year 50 percent or more of the voting stock of domestic or foreign corporations or (b) any corporation, individual, partnership, trust or association, owned at any time during the taxable year 50 percent or more of your voting stock, attach separate schedule showing with respect to each: (1), name and address, (2) percentage of stock owned, (3) date stock was acquired, and (4) the collector's office in which the income tax return of such corporation, individual, partnership, trust, or association for the last taxable year was filed.
8. Was the income of this corporation included in a consolidated return for any prior year? .... No .... If so, give name and address of corporation which filed the consolidated return and the last year for which such return was filed ....
9. Was the corporation in any way an outgrowth, result, continuation, or reorganization of a business or businesses in existence during this or any prior year since December 31, 1917? .... No .... If answer is "yes", give name and address of each predecessor business, and the date of the change in entity ....

   Upon such change, were any asset values increased or decreased? .... If answer is "yes", closing balance sheets of old business and opening balance sheets of new business must be furnished, unless furnished heretofore.
10. Is this return made on the basis of cash receipts and disbursements? .... No .... If not, describe fully what other basis or method was used in computing net income .... Accrued
11. State whether the inventories at the beginning and end of the taxable year were valued at cost, or cost or market, whichever is lower .... C. & M. .... If other basis is used, describe fully, state why used, and the date inventory was last reconciled with stock .... December 31, 1937
12. Did the corporation make a return of information on Forms 1096 and 1099 (see Instruction I) for the calendar year 1937? .... Yes

AFFIDAVIT (See Instruction F)

We, the undersigned, president (or vice president, or other principal officer) and treasurer (or assistant treasurer, or chief accounting officer) of the corporation for which this return is made, being severally duly sworn, each for himself deposes and says that this return (including any accompanying schedules and statements) has been examined by him and is, to the best of his knowledge and belief, a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Revenue Act of 1936, as amended, and the Revenue Acts of 1936 and 1937, and the regulations issued thereunder.

Subscribed and sworn to before me this

3rd day of March 1938 — William H. Schnell, Pres. (President or principal officer)

Mabel Grant — Harry L. Davis, Treasurer (Treasurer, Assistant Treasurer, or Chief Accounting Officer)

(Signature and title of officer administering oath) Com. ex. [illegible]

CORPORATE SEAL

(If this return was prepared by some person or persons other than officers or employees of the corporation, the following affidavit must be executed)

AFFIDAVIT (See Instruction F)

I/we swear (or affirm) that I/we prepared this return for the person named herein and that the return (including any accompanying schedules and statements) is a true, correct, and complete statement of all the information respecting the income tax and/or excess-profits tax liability of the person for whom this return has been prepared of which I/we have any knowledge.

Subscribed and sworn to before me this

.... day of .... 193...

(Signature of person preparing the return)

(Signature and title of officer administering oath)

(Signature of person preparing the return)

(Name of firm or employer, if any)

46 Corporation Income & Excess Profits Tax Return
Calendar Year 1937

American Dental Company

5 South Wabash Avenue
Chicago, Ill.

Deductions

Item 16 Salaries & wages (not deducted elsewhere)		
Office Salaries	10,469.78	
Errand Salaries	2,243.60	
Selling Salaries	3,856.50	
Suburban Delivery Salaries	6,351.35	
		$22,921.23

47 Corporation Income & Excess Profits Tax Return
Calendar Year 1937

American Dental Company

5 South Wabash Avenue
Chicago, Ill.

Deductions

Item 19 Schedule H

Bad Debts

Percentage of sales ascertained to be worthless	4,477.88
Amount recovered from accounts charged off	470.09
Net amount	4,007.79
Reserve for bad debts January 1, 1937	3,362.70
Increase 1937	4,477.88
	7,840.58
Accounts charged off 1937	3,190.20
Reserve for bad debts Dec. 31, 1937	4,650.38

48 Corporation Income & Excess Profits Tax Return
Calendar Year 1937

American Dental Company

5 South Wabash Avenue
Chicago, Ill.

Deductions

Item 24 Schedule K

Depreciation

Fixed Asset Account Fixtures & Equipment		
January 1, 1937	Balance	46,234.30
1937	Purchases	2,741.84
		48,976.14
Reserve for depreciation		
January 1, 1937	Balance	34,144.81
1937	Depreciation Rate 6%	1,769.12
December 31, 1937	Balance	35,913.93
Depreciation		
1937		1,769.12
Recovered from sale of item depreciated		25.00
		1,744.12

49 Corporation Income & Excess Profits Tax Return
Calendar Year 1937

American Dental Company

5 South Wabash Avenue

Chicago, Ill.

Deductions

Item 26 Schedule L

Other deductions

Errand Expense		697.41
Postage		
Inventory January 1, 1937	40.48	
Purchases	1,509.98	
	1,550.46	
Inventory December 31, 1937	43.83	
		1,506.63
Insurance		777.20
Office Supplies		
Inventory Jan. 1, 1937	566.14	
Purchases	4,236.48	
	4,802.62	
Inventory Dec. 31, 1937	517.71	
		4,284.91
Selling Expenses		1,742.72
Advertising		4,409.15
Delivery Service City		16,815.07
Delivery Service Suburban		560.45
General Expense		
Legal expenses	605.00	
Collection fees	270.00	
Traveling expenses	275.00	
Miscellaneous	752.10	
		1,902.10
		32,695.64

Filed May 7, 1941. 19 UNITED STATES BOARD OF TAX APPEALS

American Dental Company, Petitioner, *v.* Commissioner of Internal Revenue, Respondent.

Docket No. 102977. Promulgated May 7, 1941.

Income—Forgiveness of Indebtedness.—Forgiveness of debts for back rent and accrued interest, *held*, to have taken place in the taxable year rather than prior thereto; the forgiveness was not a gift; and the resulting tax liability need not be limited to the tax benefit measured in dollars received by the taxpayer in prior years when it claimed deductions on an accrual method for the rent and interest.

John E. Hughes, Esq., for the petitioner.

Jonas M. Smith, Esq., for the respondent.

The Commissioner determined a deficiency in income tax of $6,339.77 and a deficiency in excess profits tax of $404.31 for the calendar year 1937. The issue is whether or not he erred in adding to income $19,234.21, representing canceled indebtedness.

Findings of Fact.

The petitioner is a corporation engaged in the business of operating a laboratory where it does prosthetic work for the dental profession. It filed its return for the taxable year with the collector of internal revenue for the first district of Illinois.

The petitioner has occupied space in the Mallers Building in Chicago for a number of years. It negotiated a new lease in December 1933, at which time the annual rental was reduced from $15,200 to $8,400. There was then due from the petitioner $15,298.99 in back rent. The president of the petitioner notified the renting agent that the petitioner was unable to pay all of that amount and asked for an adjustment. The renting agent said he would make an adjustment, and, in April 1934, advised the petitioner that he would accept $7,500 in payment of the back rent and would cancel the rest. The petitioner paid the rent required under the lease after 1933 and paid $7,500 in addition, in 1937 in discharge of the back rent. The
20 $7,500 was paid as follows: $2,500 on February 26, 1937, at which time it also gave two notes each for $2,500; the one note was paid on April 23, 1937; and the

other note was paid on June 25, 1937. The first time that the petitioner made any entry on its books to record the cancellation of the back rent was on February 27, 1937, at which time it made an entry showing that back rent in the amount of $7,798.99 had been forgiven.

The petitioner kept its books and made its returns upon an accrual method of accounting. It had regularly accrued its rent on its books and had taken deductions for that rent on its income tax returns. Those deductions had served to offset income in like amounts.

The Mallers Building Trust, which owned the Mallers Building, credited all payments of rent which it received from the petitioner to the rent account of the petitioner in an open account without applying any particular payment to any particular charge of rent. This account continued without change or interruption at all times material hereto. An entry canceling the back rent in the amount of $7,798.99 was made in that account for the first time in 1937, when the petitioner paid the $7,500 on account of the back rent. The $7,798.99 was then charged to bad and doubtful accounts "To write off the balance of the old account as per agreement." There was then, for the first time since 1933, no balance due in the account.

The petitioner, in November 1936, owed several creditors for merchandise which they had furnished the petitioner over a period of prior years. The petitioner had been a good customer of these creditors for many years. It had given its interest-bearing notes for the amount which it owed to each creditor. It went to three of these creditors in November 1936 and asked for cancellation of interest on the notes on the ground that the creditors had made a similar arrangement with their other customers. Three creditors agreed that they would cancel all interest accruing after January 1, 1932. The petitioner claimed a deduction on its income tax return for 1936 for interest due on the notes held by the three creditors above mentioned. The first entry that the petitioner made on its books recording the forgiveness of interest on these notes was made in December 1937, when the following accounts payable were credited with the following amounts representing interest on the notes accruing after January 1, 1932:

Julius Aderer, Inc.	$10,546.06
C. L. Frame Dental Supply Co.	5,314.81
Goldsmith Brothers	1,086.87

The above amounts had been deducted by the petitioner on its income tax returns of previous years as the interest had accrued. Those deductions had offset income on those prior returns to the extent of $11,435.22.

21 The petitioner had never made any disclosure on its income tax returns showing that the rent and interest above mentioned had been canceled until its return for 1937. It did not report any of the canceled indebtedness as income on that return or on any other return. The cancellation of the indebtedness is shown for the first time on the return for 1937 under schedule B, "Reconciliation of Net Income and Analysis of Earned Surplus and Undivided Profits", as a credit to earned surplus in the amount of $25,219.65, explained "Forgiveness of debts."

The Commissioner, in determining the deficiency, held that the forgiveness of indebtedness in the amount of $25,219.65 represented taxable income for 1937 to the extent that the items represented in that total had served to offset income in prior returns, and upon that theory he included in income for 1937, $19,234.21, consisting of rent in the amount of $7,798.99 and interest in the amount of $11,435.22.

The debts for the rent and for the interest were forgiven in 1937.

Opinion.

Murdock: The petitioner, near the end of his brief, makes what might be construed as an argument that the forgiveness of this rent and this interest was not income. That point has really not been placed in issue in this case, but, in any event, the forgiveness of indebtedness to a solvent debtor is income to the extent that it frees assets of the debtor from claim. *United States* v. *Kirby Lumber Co.*, 284 U. S. 1; *Lakeland Grocery Co.*, 36 B. T. A. 289. This rule has been applied to the forgiveness of a debt for interest. *Consolidated Gas Co. of Pittsburgh*, 24 B. T. A. 331 and 901; *United States* v. *Little War Creek Coal Co.*, 104 Fed. (2d) 483; *Helvering* v. *Jane Holding Co.*, 109 Fed. (2d) 933. There was no contention here that the petitioner was insolvent.

The principal contention of the petitioner is that the forgiveness of the debt for the rent and the forgiveness of the debts for the interest occurred in prior years. It contends that the rent was forgiven in 1934 when John B.

Mallers, Jr., the renting agent of the Mallers Building, told the president of the petitioner to pay him $7,500 and forget about the rest of the back rent. Although the record contains what might seem to be a verbatim statement of the conversation between the president of the petitioner and Mallers in April 1934, we think that, in fairness to the witness, his statement of the conversation should be regarded as no more than his present recollection of the substance of the 1934 conversation. Counsel for the respondent apparently thought that the witness' statement of the 1934 conversation left ambiguous the question of whether or not the cancellation of the back rent was conditioned upon and was to await the payment of $7,500.
22 He asked the witness whether or not the forgiveness of the back rent in the amount of $7,798.99 was conditioned upon the payment of the $7,500 and the witness replied in the negative. If this were the only evidence in the record, it would justify a finding that the forgiveness took place in 1934, but there is other evidence which, if it stood alone, would lead to the conclusion that the forgiveness took place in 1937 because it was conditioned upon and was to await the payment of the $7,500. This evidence consists of entries in the books of the petitioner and, particularly, entries in the books of the creditor. Those entries show further that the indebtedness for the back rent was not actually canceled on the books until 1937. Cf. *Walker* v. *Commissioner*, 88 Fed. (2d) 170; certiorari denied, 302 U. S. 692. There is thus a conflict in the evidence and the Board must decide which evidence is the more reliable. The conversation took place six and one-half years before the hearing and it is possible that the recollection of the witness is not entirely accurate as to the terms of the agreement. We are unwilling on this state of the record to make the finding essential to the petitioner's argument, that the rent was canceled prior to 1937.

The same witness testified that the creditors to whom interest was owed had agreed unqualifiedly, in November 1936, to cancel all interest accruing on the notes after January 1, 1932. Here again, if his testimony stood alone, a finding that the debts were canceled prior to 1937 would be proper. But there is other evidence which casts serious doubt upon the accuracy of his testimony. The petitioner on its return for 1936, filed in March 1937, claimed a deduction for the interest accruing in 1936 on these same notes. The witness had signed that return and had sworn

thereon that he had examined it and found it to be correct. Furthermore, entries on the books of the petitioner recording the cancellation of the interest were made for the first time in closing the books for 1937 and disclosure that the interest and the rent had been forgiven was made for the first time on the return for 1937. The attention of the witness was called, on cross-examination, to the inconsistency of his testimony as to the rent and interest and entries pertaining thereto on the books and returns. He was unable to reconcile the inconsistency or to give any satisfactory explanation thereof. Here again, the record does not justify a finding which would reverse the determination of the Commissioner that the debts were canceled in 1937. The petitioner next contends that the cancellation of the rent and interest items represented gifts. No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity. In none of the four instances was the for-
23 giveness a gift. *Fitch* v. *Helvering*, 70 Fed. (2d) 583; *Reginald Denny*, 33 B. T. A. 738; *Rufus S. Cole*, 42 B. T. A. 1110; *Haden* v. *Commissioner*, — Fed. (2d) — (Mar. 19, 1941).

The Commissioner has included in income only that part of the forgiven debts which served to offset income in prior years. Cf. *G. M. Standifer Construction Corporation*, 39 B. T. A. 184; *Helvering* v. *Jane Holding Co., supra; Pittsburgh Brewing Co.* v. *Commissioner*, 107 Fed. (2d) 155. The petitioner does not claim that a larger amount should be included in income, but he makes a contention in his brief that the tax for 1937 can not exceed the actual tax benefit in dollars which the petitioner realized by deducting these items in prior years. This contention is rejected upon authority of *Central Loan & Investment Co.*, 39 B. T. A. 981, where a similar argument was made by the Commissioner. See also *Estate of William H. Block*, 39 B. T. A. 338, 341, where we said: "When recovery of some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs."

Decision will be entered for the respondent.

24 UNITED STATES BOARD OF TAX APPEALS. Entered May 7, 1941.

Washington.

American Dental Company, *Petitioner,*
vs.
Commissioner of Internal Revenue, *Respondent.*
} Docket No. 102977.

DECISION.

Pursuant to the determination of the Board, as set forth in its Findings of Fact and Opinion, promulgated May 7, 1941, it is

Ordered and Decided: That there are deficiencies in income and excess profits taxes in the respective amounts of $6,339.77 and $404.31 for the calendar year 1937.

Enter:

(s) J. E. Murdock,
Member.

(Seal)

Entered May 7, 1941.

25 IN THE UNITED STATES CIRCUIT COURT OF APPEALS Filed Aug. 1, 1941.

For the Seventh Circuit.

American Dental Company, *Petitioner,*
vs.
Commissioner of Internal Revenue, *Respondent.*
} B. T. A. Docket No. 102977.

PETITION FOR REVIEW AND STATEMENT OF POINTS.

Filed Aug. 1, 1941.

Comes now the above named petitioner by its counsel and hereby petitions that the decision of the Board be reviewed by the Circuit Court of Appeals for the seventh circuit according to law.

Venue.

Taxpayer's return was filed with the Collector of Internal Revenue at Chicago, Illinois.

The Board's decision was entered May 7, 1941 and a motion for rehearing was denied June 6, 1941.

Statement of Points.

The Board of Tax Appeals confirmed a deficiency of $6,339.77 income tax and $404.31 excess profits tax for the calendar year 1937. This deficiency was imposed on alleged income for debt forgiven. The issues in this case are (1) whether the forgiveness of debt was a gift. (2) Whether said debt was forgiven prior to 1937. (3) Whether the forgiveness of debt constituted "income" as that word is used in the sixteenth amendment to the Constitution and (4) Whether there was any legal
26 forgiveness of debt at all.

Petitioner's points are (1) that the forgiveness of debt was a gift; (2) that it did not constitute income as that word is used in the sixteenth amendment to the Constitution; (3) that if it was income it was not 1937 income and finally (4) if there was no gift there was no forgiveness of debt and the creditors may enforce the debt at any time.

Wm. E. Hughes,
Attorney for Petitioner.

Filed Aug. 14, 1941.

50 In the United States Circuit Court of Appeals
(Caption—102977)

PRAECIPE FOR RECORD.

Filed Aug. 14, 1941.

The Clerk will please prepare and transmit to the Circuit Court of Appeals for the seventh Circuit the following:

(1) All docket entries in the case.
(2) All pleadings in the case.
(3) Findings of fact, opinion and decision.
(4) The petition for review and statement of points.

(5) The statement of evidence.
(6) This praecipe.

John E. Hughes,
John E. Hughes,
Attorney for Petitioner.

Service is acknowledged of a copy of the above and foregoing praecipe this 14th day of August, 1941.

J. P. Wenchel,
Attorney for Respondent on Review.

UNITED STATES BOARD OF TAX APPEALS.

Entered Sept. 23, 1941.

American Dental Company,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.
} Docket No. 102977.

ORDER ENLARGING TIME.

Upon motion of counsel for petitioner, it is

Ordered that the time for transmission and delivery of the record *sur* petition for review of the above-entitled proceeding in the United States Circuit Court of Appeals for the Seventh Circuit be and it is hereby extended to November 12, 1941.

(Signed) C. R. Arundell,
Member.

Dated: Washington, D. C. September 23, 1941.

Now, Oct. 30, 1941, the foregoing is certified from the record as a true copy.

B. D. Gamble,
B. D. Gamble,
(Seal) *Clerk, U. S. Board of Tax Appeals.*

UNITED STATES BOARD OF TAX APPEALS.

• • (Caption—102977) • •

CERTIFICATE.

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 50, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 30th day of September, 1941.

B. D. Gamble,
Clerk,
United States Board of Tax Appeals.

(Seal)

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

I, Kenneth J. Carrick, Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, do hereby certify that the foregoing printed pages contain a true copy of the printed record, printed under my supervision and filed on the twenty-fifth day of November, 1941, in the following entitled cause:

Cause No. 7847

AMERICAN DENTAL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

as the same remains upon the files and records of the United States Circuit Court of Appeals for the Seventh Circuit.

In testimony whereof I hereunto subscribe my name and affix the seal of said United States Circuit Court of Appeals for the Seventh Circuit, at the City of Chicago, this seventeenth day of July A. D. 1942.

[SEAL] KENNETH J. CARRICK,
Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.

At a regular term of the United States Circuit Court of Appeals for the Seventh Circuit held in the City of Chicago and begun on the seventh day of October in the year of our Lord one thousand nine hundred and forty-one and of our Independence the one hundred and sixty-fifth.

7847

AMERICAN DENTAL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for Review of Decision of the United States Board of Tax Appeals

And, to wit: On the fifteenth day of May 1942, there was filed in the office of the Clerk of this Court, the opinion of the Court, which said opinion is in the words and figures following, to wit:

In the United States Circuit Court of Appeals
for the Seventh Circuit

No. 7847. October Term, 1941, and April Session, 1942

AMERICAN DENTAL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for Review of Decision of the United States Board of Tax Appeals

May 15, 1942

Before MAJOR, KERNER, and MINTON, Circuit Judges.

MINTON, Circuit Judge. The petitioner has appealed from a decision of the Board of Tax Appeals confirming the Commissioner's determination of a deficiency in petitioner's income tax for 1937. The question we are confronted with at the threshold is whether the cancellation of certain indebtedness owed by the petitioner in the amount of $19,234.21 constituted taxable income.

In December 1933 petitioner was indebted to its landlord for past-due rent in the sum of $15,298.99. On December 19, 1933 when petitioner's president and landlord's agent were negotiating a new lease, petitioner's president asked for an adjustment on the past-due rent. The landlord's agent replied:

"Well, I will make an adjustment of this item. Go ahead and sign up the new lease, and so forth, and I will give it a little thought and will let you hear from me."

The new lease, which reduced the annual rent from $15,200 to $8,400, was signed. Nothing more was said about adjustment of the past-due rent until April 1934, when petitioner again took it up with the landlord's agent, who said:

"Pay me $7,500, and I will call it square and forget the rest of it."[1]

The petitioner in 1936 was also indebted to three firms for interes upon past-due accounts for merchandise. In November 1936 petitioner's president secured from these three firms separately adjustments in these past-due accounts, cancelling the interest accrued after January 1932. Petitioner kept its books and made its income tax return upon an accrual basis, and up to 1937 it took deductions for the rent and interest which were allegedly adjusted, as we have indicated. The rent forgiven offset income of $7,798.99, and the indebtedness for interest forgiven offset income of $11,435.22. There is no question of wilful misrepresentation or fraudulent intent. The

[1] The Board found: "The petitioner * * * negotiated a new lease in December 1933 at which time the annual rental was reduced from $15,200 to $8,400. There was then due from the petitioner $15,298.99 in back rent. * * * The renting agent said he would make an adjustment, and, in April 1934, advised the petitioner that he would accept $7,500 in payment of the back rent and would cancel the rest.

Commissioner concedes in his brief that there is no question of estoppel.

In 1937 petitioner paid in three equal installments $7,500 to its landlord, and in its income tax return for 1937, it acknowledged as a "credit to surplus" the cancelled rent and interest. The Board held that the cancelled rent and the cancelled interest in the sum of $19,234.21 constituted income taxable to the petitioner in 1937 and were subject to the undistributed profits tax, and upon this basis confirmed the Commissioner's determination of a deficiency.

The Government freely conceded that unless the forgiveness of indebtedness in each of these instances was based upon a consideration, it would amount to a gift, and gifts are not taxable as income to the donee. Article 64 of Regulation 77 promulgated by the Commissioner of Internal Revenue reads as follows:

"* * * If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. * * *"

Were these debts cancelled by the creditor for the benefit of the debtor and without consideration? The negotiations for the new lease took place in December 1933, and the lease was then agreed upon and executed. At that time, the taxpayer-petitioner asked for an adjustment of the past-due rent account. The landlord's agent said: "* * * I will make an adjustment of this item. Go ahead, and sign up the new lease, and so forth, and I will give it a little thought and will let you hear from me." That terminated the negotiations at that time. No promise was made as to what the adjustment would be. The matter of debt forgiveness was not agreed upon but was left for future negotiations. If the landlord had said: "If you will make the new lease, I will reduce your indebtedness to $7,500," the making of the new lease might have constituted consideration for the promise to forgive. But that was not done. The landlord said in substance: "You go ahead and make the new lease and I will think it over and let you know later." It was all left to future negotiations. The future negotiations followed the next April, when the landlord's agent said: "Well, pay me $7,500 and I will call it square, and forget the rest of it." The petitioner-tenant said: "Well, I haven't $7,500." The landlord's agent replied: "You worry about raising the $7,500; get busy and raise it and pay it when you can, and forget the rest of it." In the year 1937, the taxpayer-tenant paid the $7,500 in three equal installments. There was no consideration to the landlord for the cancellation of the debt. There is no evidence that the landlord, if it had been unyielding, could not have collected the whole of its rent account. This it did not do. It forgave all but $7,500 of the rent for no consideration whatsoever to the landlord, and merely as a benefit to the debtor.

In the negotiations for a reduction of the indebtedness for interest due, there was no semblance of a consideration. The debtor-taxpayer

went to three of its creditors and said in substance: "We don't get any interest on our past-due accounts. You should not charge us with interest on ours to you." The creditors readily agreed and forgave the debt. The creditors might have expected more business in the future, but the debtor-taxpayer did not promise any. Certainly the creditors' expectation was not consideration. The transaction was a pure cancellation of indebtedness, without any consideration and for the benefit of the debtor.

Since, therefore, there was no consideration for the cancelled debts, and the cancellations inured only to the benefit of the debtor, the amount of the debts as cancelled is a gift from the creditors to the debtor, within the meaning of the Treasury Department's regulations, and the debtor was not required to include it in gross income.

The Board stated in its opinion:

"No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity. In none of the four instances was the forgiveness a gift."

Suppose the creditors did act for purely business reasons. As long as there was no consideration for the cancellation, the intent to give necessarily followed. Evidently the Board confused intent with motive. There is no evidence that the creditors did that which they did not intend to do. The creditors' motives are immaterial. South Dakota v. North Carolina, 192 U. S. 286, 310, 24 S. Ct. 269, 48 L. Ed. 448.

Our decision may result in the Government getting no tax, although the taxpayer had benefited by deducting the rent and interest accrued. The taxpayer had offered to pay the Department all the tax it had saved by taking the deductions for accrued rent and interest, but the Commissioner refused and insisted that the entire sum be treated as income for the year 1937. The unfairness of the Government's position is evidenced by taxing this sum of $19,234.21 as excess profits received in 1937. Of course, the taxpayer never received a nickel it could have distributed as dividends. It received cancellation of debts for services and goods already consumed. How it could have distributed that as a dividend is not apparent. It is not difficult to imagine what would have happened to this debtor-taxpayer if it had inveigled its creditors into cancelling these debts on the basis that the debtor was hard up, and then the debtor had distributed a like amount in dividends!

We therefore hold that the indebtedness was cancelled for the benefit of the debtor and without consideration, and was not taxable. The decision of the Board of Tax Appeals is

Reversed.

A true Copy:
Teste:

_____,
Clerk of the United States Circuit Court of Appeals for the Seventh Circuit.

And on the same day, to wit: On the fifteenth day of May 1942, the following proceedings were had and entered of record, to wit:

Friday, May 15, 1942

Court met pursuant to adjournment

Before Hon. J. Earl Mayor, Circuit Judge; Hon. Otto Kerner, Circuit Judge; Hon. Sherman Minton, Circuit Judge

7847

American Dental Company, petitioner

vs.

Commissioner of Internal Revenue, respondent

Petition for Review of Decision of the United States Board of Tax Appeals.

This cause came on to be heard on the transcript of the record from the United States Board of Tax Appeals, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the decision of the United States Board of Tax Appeals entered in this cause on May 7, 1941, be, and the same is hereby, reversed, and that this cause be, and the same is hereby, remanded to the said Board of Tax Appeals.

And afterwards, to wit: On the ninth day of June 1942, there was filed in the office of the Clerk of this Court, a motion for revision of the opinion, which said motion is in the words and figures following, to wit:

No. 7847

In the United States Circuit Court of Appeals for the Seventh Circuit

American Dental Company, petitioner

vs.

Commissioner of Internal Revenue, respondent

On Petition for Review of Decision of the United States Board of Tax Appeals

Motion for revision of the opinion

Now comes the respondent by his attorney, Samuel O. Clark, Jr., Assistant Attorney General, and respectfully moves the Court to revise the portion of its opinion in the above-entitled case, which reads as follows:

"The Government freely conceded that unless the forgiveness of indebtedness in each of these instances was based upon a consideration,

it would amount to a gift, and gifts are not taxable as income to the donee."

I have discussed this question with Mr. Newton K. Fox, who argued the case for the respondent. He informs me that, while agreeing that a gift is not taxable as income, he did not mean to concede that absence of consideration would be fatal to the Government's basic contention that no gift to the taxpayer was intended. Rather than intending to make a gift, we argued, the creditor had cancelled the indebtedness for business reasons. Since this amount had previously been deducted from gross income though not paid, it was our view that it should be treated as taxable income when the debt was cancelled.

Although the respondent's brief also suggested that there was consideration, the Court is no doubt aware that no concession appears in the brief that consideration was essential. This accords with the position which we have consistently maintained in other Circuits.

In view of the foregoing, it is moved that the Court revise its opinion by deleting the words "The Government freely conceded that," appearing in the fourth paragraph on page two of the printed opinion.

Respectfully submitted.

SAMUEL O. CLARK, JR.,
Samuel O. Clark, Jr.,
Assistant Attorney General,
Attorney for the Respondent.

Service of a copy of the within motion is acknowledged this 8th day of June 1942.

JAMES O'CALLAGHAN,
Attorney for the Petitioner.
By J. T. LOYOREI.

And afterwards, to wit: On the fifteenth day of June, 1942, the following further proceedings were had and entered of record, to wit:

Monday, June 15, 1942.

Court met pursuant to adjournment

Before Hon. SHERMAN MINTON, Circuit Judge

7847

AMERICAN DENTAL COMPANY, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Petition for review of Decision of the United States Board of Tax Appeals

It is ordered that the motion of counsel for the respondent for revision of the opinion of this Court filed on May 15, 1942, be, and it is hereby, denied.

United States Circuit Court of Appeals
for the Seventh Circuit

I, Kenneth J. Carrick, Clerk of the United States Circuit Court of Appeals for the Seventh Circuit, do hereby certify that the foregoing typewritten and printed pages contain a true copy of the opinion of this Court filed May 15, 1942, judgment entered thereon May 15, 1942, motion for revision of opinion filed June 9, 1942, and order entered June 15, 1942, denying motion for revision of opinion, in the following entitled cause: Cause No. 7847. American Dental Company, petitioner vs. Commissioner of Internal Revenue, respondent, as the same remains upon the files and records of the United States Circuit Court of Appeals for the Seventh Circuit.

In testimony whereof I hereunto subscribe my name and affix the seal of said United States Circuit Court of Appeals for the Seventh Circuit, at the City of Chicago, this seventeenth day of July A. D. 1942.

[SEAL]

KENNETH J. CARRICK,
Clerk of the United States Circuit Court
of Appeals for the Seventh Circuit.

U. S. GOVERNMENT PRINTING OFFICE: 1942

Supreme Court of the United States

No. 303, October Term, 1942

Order allowing certiorari

Filed October 12, 1942

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Seventh Circuit is granted, and the case is transferred to the summary docket.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

196610—42 U. S. GOVERNMENT PRINTING OFFICE: 1942

FILE COPY

No. 303

In the Supreme Court of the United States

OCTOBER TERM, 1942

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

AMERICAN DENTAL CO.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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CITATIONS

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No. —

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v.

AMERICAN DENTAL CO.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Seventh Circuit entered in the above entitled case on May 15, 1942, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 38–42) is reported in 44 B. T. A. 425. The opinion of the Circuit Court of Appeals (R. 47–50) is reported in 128 F. (2d) 254.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 15, 1942 (R. 51). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether creditors' cancellations in 1937 for business reasons of debts for past due rents and interest owed by the taxpayer and accrued and deducted as business expenses in its returns for years prior to 1937 resulted in taxable income to the taxpayer or, as held by the Circuit Court of Appeals, constituted gifts which were exempt from income tax.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Revenue Act of 1936, c. 690, 49 Stat. 1648, and of Treasury Regulations 94, promulgated under the Act, are set forth in the Appendix, *infra*, pp. 11–12.

STATEMENT

The Board of Tax Appeals found the following facts (R. 38–40): The respondent taxpayer is a corporation engaged in operating a laboratory where it does prosthetic work for the dental profession. For a number of years it has occupied space in the Mallers Building in Chicago. In December 1933 it negotiated a new lease which re-

duced the annual rental from $15,200 to $8,400. There was then due from the taxpayer $15,298.99 in back rent. Its president notified the rental agent that it was unable to pay all of that amount and requested an adjustment. The agent said that he would make an adjustment. The taxpayer regularly paid the rent under the new lease and in April 1934 the agent advised the taxpayer that he would accept $7,500 in payment of the back rent and would cancel the remainder. In 1937 taxpayer paid $7,500 in discharge of the back rent and for the first time made an entry on its books showing that back rent in the amount of $7,798.99 had been forgiven. In the same year the landlord likewise for the first time made an entry on its books cancelling the back rent in that amount (R. 38–39).

The taxpayer kept its books and made its returns upon an accrual basis of accounting. During the years prior to 1934 in which it had failed to pay its rent, it had regularly accrued the rent on its books and taken deductions therefor in its income-tax returns. Those deductions served to offset income in like amounts for those years (R. 39).

In November 1936 taxpayer was indebted to several creditors for merchandise which they had furnished it over a period of years and for which it had given its interest-bearing notes. It had been a good customer of these creditors for many years. During the month mentioned it requested

three of these creditors to cancel interest on the notes on the ground that they had made similar arrangements with their other customers. The three creditors agreed to cancel all interest accruing after January 1, 1932. The first entry that the taxpayer made on its books showing that the interest had been forgiven was made in December 1937 when the accounts payable to the three creditors were credited with a total of $16,947.74 representing interest on the notes accruing after January 1, 1932. All of this amount had been deducted by the taxpayer in its returns for the years, including 1936, during which the interest had accrued. The deductions had offset income on those returns to the extent of $11,435.22 (R. 39–40).

Neither in its return for 1937 nor in any other return did taxpayer report any of the cancelled rent or interest as income. The Commissioner in determining deficiencies in income and excess profits tax for 1937 held that the cancelled items constituted taxable income for that year to the extent that they had served to offset income in prior years. Accordingly, he included in taxpayer's income for 1937 the forgiven rent in the amount of $7,798.99 and the cancelled interest in the amount of $11,435.22 (R. 40).

The Board stated in its opinion that no evidence was introduced to show a donative intent on the part of any creditor and that the evidence indicated that the creditors "acted for purely business reasons and did not forgive the debts for

altruistic reasons or out of pure generosity" (R. 42). Holding that there was no gift, it affirmed the action of the Commissioner in treating the items as taxable income for 1937 and in determining deficiencies (R. 42).

The Circuit Court of Appeals for the Seventh Circuit reversed the decision of the Board on the ground that the cancellations constituted gifts exempt from income tax since, as the court concluded, they were made without consideration and for the taxpayer's benefit (R. 50).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the cancellations of past due indebtednesses for interest and rent constituted gifts exempt from income tax.

2. In failing to hold that the cancellations resulted in taxable income.

3. In relying upon Article 64 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, instead of Article 22 (a)–14 of Treasury Regulations 94, promulgated under the Revenue Act of 1936.

4. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. Decisions of this Court and of the lower federal courts have established that in a variety of circumstances similar to those presented by the instant case a debtor realizes taxable income when the debt is forgiven or settled or otherwise sat-

isfied for less than its face value. These decisions usually have been based either on the theory that there is an accession to income in that assets of the debtor are made available for other purposes (*United States* v. *Kirby Lumber Co.*, 284 U. S. 1; *Helvering* v. *American Chicle Co.*, 291 U. S. 426)[1] or on the theory that a restoration to income should be required where, as in the present case, deductions on account of the debt were taken in the debtor's returns for prior years and had the effect of offsetting income for those years. *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 352.[2] Whichever of these theories be deemed ap-

[1] Interest forgiven (*Helvering* v. *Jane Holding Corp.*, 109 F. (2d) 933 (C. C. A. 8), certiorari denied, 310 U. S. 653, rehearing denied, 311 U. S. 725; *Walker* v. *Commissioner*, 88 F. (2d) 170 (C. C. A. 5), certiorari denied, 302 U. S. 692); principle of indebtedness forgiven or settled by compromise (*Haden Co.* v. *Commissioner*, 118 F. (2d) 285 (C. C. A. 5), certiorari denied, 314 U. S. 622; *United States* v. *Little War Creek Coal Co.*, 104 F. (2d) 483 (C. C. A. 4)).

[2] Items deducted as expenses for which there was subsequent reimbursement (*Buffalo Union Furnace Co.* v. *Helvering*, 72 F. (2d) 399, 403 (C. C. A. 2)); settlement with employees for less than amounts previously deducted as expense (*Commissioner* v. *Vandeveer*, 114 F. (2d) 719, 722–723 (C. C. A. 6)); debts deducted as bad in prior years and subsequently paid (*Commissioner* v. *Liberty Bank & Trust Co.*, 59 F. (2d) 320 (C. C. A. 6)); *Askin & Marine Co.* v. *Commissioner*, 66 F. (2d) 776 (C. C. A. 2)); wages deducted as expense but uncollected are income when subsequently charged back to profit and loss (*Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7), certiorari denied, 284 U. S. 618; *Charleston & W. C. Ry. Co.* v. *Burnet*, 50 F. (2d) 342 (App. D. C.)); unclaimed deposits credited to surplus (*Boston Consol. Gas Co.* v. *Commissioner*, 128 F. (2d) 473 (C. C. A. 1)).

plicable here, or whether both be, the decision of the court below represents a departure from the uniform result reached in the cases cited.

2. In holding that the cancellations of rent and interest constituted gifts exempt from income tax, the decision is in conflict with *Haden Co.* v. *Commissioner of Internal Revenue*, 118 F. (2d) 285 (C. C. A. 5), certiorari denied, 314 U. S. 622, and is erroneous. The creditor corporation in the *Haden Co.* case cancelled an indebtedness for the purchase price of materials and for rent owed by the taxpayer company. The latter had the same stockholders and officers and directors as the creditor and was engaged in selling the creditor's products to the retail trade. The Board of Tax Appeals found that the cancellation, although voluntary, was made in recognition of business benefits which would result and was not a gift.[3] The Circuit Court of Appeals for the Fifth Circuit sustained this finding as proper and affirmed the Board's holding that the cancelled debt, which the taxpayer had deducted in its returns for prior years, was taxable income in the year of cancellation to the extent that it made the taxpayer solvent.

The conflicting decision of the court below in the instant case is based (a) on the court's assumption that a gift within the meaning of the statu-

[3] The memorandum decision of the Board in the *Haden Co.* case is not reported but is included in the record (pp. 14–18) in the case on file in this Court, No. 171, October Term, 1941.

tory provision excepting property acquired by "gift, bequest, devise, or inheritance" from the definition of income is exempt from tax as income even though the taxpayer took deductions which offset income in prior years; and (b) on the court's holding that such a gift must necessarily be intended if the cancellation is without consideration and if, as would always be the case, it benefits the debtor.

Assuming, but not conceding, that the court's assumption is valid, its holding plainly goes beyond established law,[4] as was recently said by the Circuit Court of Appeals for the Third Circuit in commenting upon the decision.[5] The voluntary character of a payment or of a discharge of indebtedness is not alone sufficient to establish it as a gift. There must be a donative intent and this is not present where payments or discharges are motivated by business considera-

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[4] The court erroneously stated in its opinion that (R. 49): "The Government freely conceded that unless the forgiveness of indebtedness in each of these instances was based upon a consideration, it would amount to a gift, and gifts are not taxable as income to the donee." No such concession was made on brief or otherwise. However, the court denied a motion to delete the statement from the opinion (R. 51–52).

In its opinion the court also relied upon Article 64 of Treasury Regulations 77, promulgated under the Revenue Act of 1932. The applicable regulation is found, however, in Article 22 (a) 14 of Treasury Regulations 94, promulgated under the Revenue Act of 1936.

[5] *Sportswear Hosiery Mills* v. *Commissioner* (C. C. A. 3), decided June 25, 1942, not officially reported but found in 1942 C. C. H., Vol. 4, Par. 9565, fn. 29.

tions; it is present only where they are made without "incentive of anticipated benefit of any kind beyond the satisfaction which flows from the performance of a generous act." Cf. *Bogardus* v. *Commissioner*, 302 U. S. 34, 41, and cases cited in footnote.[6]

Although in the instant case the burden of proof was on the taxpayer,[7] the Board stated that the evidence failed to show a donative intent but indicated, on the contrary, that the cancellations were made for business reasons (R. 42). Since this is an inference of fact and is supported by the evidence with respect to the business relationships existing between the taxpayer and its creditors and with respect to the manner in which the cancellations were sought and obtained, it was conclusive on the court below. To the extent that the court failed to adopt the Board's finding, its decision conflicts with the familiar rule recently applied in *Wilmington Trust Com-*

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[6] *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 730; *Sportswear Hosiery Mills* v. *Commissioner*, *supra*; *Fitch* v. *Helvering*, 70 F. (2d) 583, 585 (C. C. A. 8); *Noel* v. *Parrott*, 15 F. (2d) 669, 671 (C. C. A. 4); *Weagant* v. *Bowers*, 57 F. (2d) 679 (C. C. A. 2); *Fisher* v. *Commissioner*, 59 F. (2d) 192 (C. C. A. 2); *Bass* v. *Hawley*, 62 F. (2d) 721 (C. C. A. 5).

"The instances are many in which purpose or state of mind determines the incidence of an income tax." *Helvering* v. *National Grocery Co.*, 304 U. S. 282, 289.

[7] *Reinecke* v. *Spalding*, 280 U. S. 227, 232–233; *Burnet* v. *Houston*, 283 U. S. 223, 227–228; *Welch* v. *Helvering*, 290 U. S. 111, 115; and *Fitch* v. *Helvering*, 70 F. (2d) 583, 585–586 (C. C. A. 8).

pany v. *Helvering*, decided April 27, 1942, No. 775, October Term, 1941.

CONCLUSION

It is respectfully submitted that this petition for a writ of certiorari be granted.

CHARLES FAHY,
Solicitor General.

AUGUST 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:

* * * * *

(3) *Gifts, Bequests, and Devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income); * * *

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 22 (a)—14. *Cancellation of indebtedness.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an in-

dividual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22 (a)—18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. * * *

U. S. GOVERNMENT PRINTING OFFICE: 1943

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BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 38–42) is reported in 44 B. T. A. 425. The opinion of the circuit court of appeals (R. 47–50) is reported in 128 F. 2d 254.

JURISDICTION

The judgment of the circuit court of appeals was entered on May 15, 1942. (R. 51.) The petition for a writ of certiorari was filed on August 14, 1942, and was granted on October 12,

1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether creditors' cancellations, for business reasons, of debts for past due rent and interest owed by the taxpayer, which amounts had been accrued and deducted as business expenses in its tax returns for years prior to 1937, resulted in taxable income to the taxpayer or, as held by the Circuit Court of Appeals, constituted gifts which were exempt from income tax.

2. Whether the cancellations were properly taxable as income for 1937.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Revenue Act of 1936, c. 690, 49 Stat. 1648, and of Treasury Regulations 94, promulgated under the Act, are set forth in the Appendix, *infra*, pp. 19–21.

STATEMENT

The facts as found by the Board of Tax Appeals may be summarized as follows (R. 38–40):

The respondent taxpayer is a corporation engaged in operating a laboratory where it does prosthetic work for the dental profession. For a number of years it has occupied space in the Mallers Building in Chicago. In December, 1933,

it negotiated a new lease which reduced the annual rent from $15,200 to $8,400. There was then due from the taxpayer $15,298.99 in back rent. Its president notified the rental agent that it was unable to pay all of that amount and requested an adjustment. The agent said that he would make an adjustment. The taxpayer regularly paid the rent under the new lease and in April, 1934, the agent advised the taxpayer that he would accept $7,500 in payment of the back rent and would cancel the remainder. In 1937 taxpayer paid $7,500 in discharge of the back rent and for the first time made an entry on its books showing that back rent in the amount of $7,798.99 had been forgiven. In the same year the landlord likewise for the first time made an entry on its books cancelling the back rent in that amount. (R. 38–39.)

The taxpayer kept its books and made its tax returns upon an accrual basis of accounting. During the years prior to 1934 in which it had failed to pay its rent, it had regularly accrued the rent on its books and taken deductions therefor in its tax returns. Those deductions served to offset income in like amounts for those years. (R. 39.)

In November, 1936, taxpayer was indebted to several creditors for merchandise which they had furnished it over a period of years and for which it had given its interest-bearing notes. It had

been a good customer of these creditors for many years. During the month mentioned it requested three of these creditors to cancel interest on the notes on the ground that they had made similar arrangements with their other customers. The three creditors agreed to cancel all interest accruing after January 1, 1932. The first entry that the taxpayer made on its books showing that the interest had been forgiven was made in December, 1937, when the accounts payable to the three creditors were credited with a total of $16,947.74 representing interest on the notes accruing after January 1, 1932. All of this amount had been deducted by the taxpayer in its tax returns for the years, including 1936, during which the interest had accrued. The deductions had offset income on those returns to the extent of $11,435.22. (R. 39–40.)

Neither in its return for 1937 nor in any other return did taxpayer report any of the cancelled rent or interest as income. The Commissioner in determining deficiencies in income and excess profits tax for 1937 held that the cancelled items constituted taxable income for that year to the extent that they had served to offset income in prior years. Accordingly, he included in taxpayer's income for 1937 the forgiven rent in the amount of $7,798.99 and the cancelled interest in the amount of $11,435.22. (R. 40.)

The Board stated in its opinion that no evidence was introduced to show a donative intent

on the part of any creditor and that the evidence indicated that the creditors "acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity" (R. 42). Holding that there was no gift, it affirmed the action of the Commissioner in treating the items as taxable income for 1937 and in determinating deficiencies (R. 42).

The Circuit Court of Appeals for the Seventh Circuit reversed the decision of the Board on the ground that the cancellations constituted gifts exempt from income tax since, as the court concluded, they were made without consideration and for the taxpayer's benefit (R. 50).

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred:

1. In holding that the cancellations of past due indebtedness for interest and rent constituted gifts exempt from income tax.

2. In failing to hold that the cancellations resulted in taxable income.

3. In relying upon Article 64 of Treasury Regulations 77, promulgated under the Revenue Act of 1932, instead of Article 22 (a)–14 of Treasury Regulations 94, promulgated under the Revenue Act of 1936.

SUMMARY OF ARGUMENT

The gains resulting to a solvent debtor from the cancellation of past due rent and interest obliga-

tions which he had accrued and deducted in prior years from income, are taxable income in the year of cancellation. This result is required both by the doctrine of *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, that the cancellation freed assets of the taxpayer for other purposes, and under the theory of *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, that the cancellations effected a restoration to income of previously deducted items.

The cancellations were negotiated as normal business transactions and were made by the creditors in anticipation of commercial benefit with no intention to make a gift. The cancellations therefore resulted in taxable income rather than gifts.

On conflicting evidence the Board correctly determined that the debts were cancelled in 1937. The finding is supported by substantial evidence and is conclusive on appeal.

ARGUMENT

The Commissioner of Internal Revenue correctly determined the deficiency in respondent's 1937 income and excess profits tax return if the cancellations here involved resulted in taxable income to respondent and if that income was taxable for the year 1937. The court below found it unnecessary to decide the latter question because it determined that the cancellations were made as

gifts and therefore did not constitute taxable income. The respondent has indicated that it will contend in this Court that the cancellations, even if not gifts, did not result in taxable income (Brief in Opposition, p. 7). We submit that the cancellations of indebtedness, if not made as gifts, constituted taxable income, that they were not made as gifts, and that they resulted in income to the taxpayer which is properly taxable for 1937.

I

THE CREDITORS' CANCELLATION OF DEBTS FOR PAST DUE RENT AND INTEREST OWED BY THE TAXPAYER, MADE FOR BUSINESS REASONS, RESULTED IN TAXABLE INCOME TO THE TAXPAYER

A. *The forgiveness of indebtedness here, if not made as a gift, results in taxable income to the debtor.*

By the cancellation of the debts here involved a portion of the assets of the debtor were freed for other purposes. That such a release from obligations, if not made as a gift or as a capital contribution, results in the realization of taxable income was established in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1. In a wide variety of circumstances, e. g., by the repurchase of bonds at less than their issuing value by the issuer (*United States* v. *Kirby Lumber Company*, 284 U. S. 1), or his successor in obligation (*Helvering* v. *American Chicle Company*, 291 U. S. 426); or by the compromise of the principal of

(*Haden Co.* v. *Commissioner*, 118 F. (2d) 285 (C. C. A. 5), certiorari denied, 314 U. S. 622; *United States* v. *Little War Creek Coal Co.*, 104 F. (2d) 483 (C. C. A. 4)), or interest on, an obligation (*Helvering* v. *Jane Holding Corp.*, 109 F. (2d) 933 (C. C. A. 8), certiorari denied, 310 U. S. 653, rehearing denied, 311 U. S. 725; *Walker* v. *Commissioner*, 88 F. (2d) 170 (C. C. A. 5), certiorari denied, 302 U. S. 692), the reduction or cancellation of a debt has usually been held to result in taxable income. And the same result is required by the applicable Treasury regulations. (See Treasury Regulations No. 94, Article 22 (a)–14, promulgated under Revenue Act of 1936.)

Occasionally lower federal courts have attempted to qualify the doctrine thus enunciated.[1] Whatever may be said of the merits of some of these attempted modifications,[2] none of them is involved here. Thus it has been held that if the debtor is insolvent he realizes no income by the cancellation of portions of his indebtedness.[3]

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[1] See footnotes 3, 4, 5, 6, 7, *infra*.

[2] See, Warren and Sugarman, *Cancellation of Indebtedness and Its Tax Consequences*, 40 Col. L. Rev. 1326; Darrell, *Discharge of Indebtedness and the Federal Income Tax*, 53 Harv. L. Rev. 977; Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 Yale L. J. 1153.

[3] Cf. *Burnet* v. *John F. Campbell Co.*, 50 F. (2d) 487 (App. D. C.); *Dallas T. & T. Warehouse Co.* v. *Commissioner*, 70 F. (2d) 95 (C. C. A. 5); *Commissioner* v. *Simmons Gin Co.*, 43 F. (2d) 327 (C. C. A. 10).

But this suggestion, even if valid,[4] has no bearing on this case, since the taxpayer is not and was not insolvent. Similarly, it was suggested in *Commissioner* v. *Rail Joint Co.*,[5] 61 F. (2d) 751 (C. C. A. 2), that if the obligation was originally contracted without anything of value being received therefor its cancellation would not result in income to the debtor. But the facts in this case do not present that problem either. Nor, in view of the nature of the transactions and the relationship of its participants, can the cancellations here be regarded as capital contributions,[6] or reductions in the purchase price of property rather than income.[7] In short, even the qualifications which have gained some currency, albeit disputed, in the lower federal courts cannot be urged to remove the transactions in this case from the doctrine of the *Kirby* case. The taxpayer, having

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[4] See, Warren and Sugarman, *supra*, at 1351–1356; Darrell, *supra*, at 988–990; Surrey, *supra*, at 1157–1167; cf. *Haden Co.* v. *Commissioner*, *supra*.

[5] Cf. *Helvering* v. *American Chicle Co.*, *supra*; *Commissioner* v. *Coastwise Transportation Corp.*, 71 F. (2d) 104 (C. C. A. 1).

[6] Cf. *Commissioner* v. *Auto Strop Safety Razor Co.*, 74 F. (2d) 226 (C. C. A. 2); *Carroll-McCreary Co.* v. *Commissioner*, 124 F. (2d) 303 (C. C. A. 2). (In these cases the applicable Treasury regulations expressly provided that such a cancellation results in a contribution to capital.) But cf. *Helvering* v. *Jane Holding Corp.*, 109 F. (2d) 933 (C. C. A. 8).

[7] Cf. *Hirsch* v. *Commissioner*, 115 F. (2d) 656 (C. C. A. 7); but cf. *Sportwear Hosiery Mills* v. *Commissioner*, 129 F. (2d) 376, 383 (C. C. A. 3).

by the cancellation of his debts obtained the free use of assets which presumably would have gone to pay those debts, realized income which was properly taxed.

That the taxpayer had in prior years' returns deducted the amounts here cancelled also points to the conclusion that the gains now realized were properly taxable. The lower federal courts have consistently recognized that the reacquisition or release of amounts previously deducted from income are taxable as restorations to income in the year of reacquisition. *Helvering* v. *Jane Holding Corp., supra.; Helvering* v. *State-Planters Bank & Trust Co.*, 130 F. (2d) 44 (C. C. A. 4).* And this Court, while never squarely ruling on

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* Among the many instances of taxation as restored income of previously deducted, but ultimately reacquired, items are: Items deducted as expenses for which there was subsequent reimbursement (*Buffalo Union Furnace Co.* v. *Helvering*, 72 F. (2d) 399, 403 (C. C. A. 2)); settlement with employees for less than amounts previously deducted as expense (*Commissioner* v. *Vandeveer*, 114 F. (2d) 719, 722–723 (C. C. A. 6)); debts deducted as bad in prior years and subsequently paid (*Commissioner* v. *Liberty Bank & Trust Co.*, 59 F. (2d) 320 (C. C. A. 6)); *Askin & Marine Co.* v. *Commissioner*, 66 F. (2d) 776 (C. C. A. 2)); wages deducted as expense but uncollected are income when subsequently charged back to profit and loss (*Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7), certiorari denied, 284 U. S. 618; *Charleston & W. C. Ry. Co.* v. *Burnet*, 50 F. (2d) 342 (App. D. C.)); unclaimed deposits credited to surplus (*Boston Consol. Gas Co.* v. *Commissioner*, 128 F. (2d) 473 (C. C. A. 1)).

the point, has suggested that items of income previously deducted or accrued as reserve become taxable when released. *Maryland Casualty Co.* v. *United States,* 251 U. S. 342, 352; [see also *S. Rossin & Sons* v. *Commissioner,* 113 F. (2d) 652, 654 (C. C. A. 2)]; cf. *Burnet* v. *Sanford & Brooks Co.,* 282 U. S. 359. Just as in the latter case, the reimbursement of earlier expenses was held to constitute income, so here, the release from the obligation to pay items previously deducted as accrued must be surcharged to income in order that the taxpayer's returns accurately reflect the facts of its financial affairs. Cf. *Buffalo Union Furnace Co.* v. *Helvering,* 72 F. (2d) 399, 403 (C. C. A. 2).*

Accordingly, under both the doctrine of the *Kirby* case and the theory of the *Maryland Casualty* case, the forgiven indebtedness, if not made as a gift (within the meaning of Section 22 (b) (3) of the Revenue Act of 1936), was properly taxable as income to the debtor. The circuit

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* In this connection it should be noted that while the taxpayer's income for 1937 was treated as being increased only to the extent that the amount of deductions taken for accrued rent and interest offset income in prior years' tax returns (R. 6, 40) the rationale of these cases properly authorizes inclusion of the entire amount previously deducted. Cf. *Helvering* v. *State-Planters Bank & Trust Co., supra.* Compare Section 116 of the Revenue Act of 1942 (adding subparagraph (12) to Section 22 of The Internal Revenue Code), providing for the first time that the recovery of a previously deducted item (here, bad debts) shall be taxed only to the extent that a tax benefit was received in previous years.

court of appeals did not question this conclusion since its decision turned upon whether the transactions resulted in a gift.

B. *The cancellation of indebtedness was not made as a gift within the meaning of Section 22 (b) (3) of the Revenue Act of 1936*

In holding that the creditor's cancellations in this case were "gifts," the court below relied solely on the fact that no "consideration" (*i. e.*, nothing of commercial value) was received by the creditors for forgiving the debts.[10] But the refinements of the law of contracts do not mark out the boundaries of tax conceptions. A broader inquiry than simply whether the giver received "consideration" which would bind him contractually must be made in determining whether given disbursals result in gifts rather than taxable income under Section 22 of the Revenue Act of 1936. The intention of the person making the payment

[10] In its opinion the court erroneously relied upon Article 64 of Treasury Regulations 77, promulgated under the Revenue Act of 1932. The applicable regulation is found, however, in Article 22 (a)-14 of Treasury Regulations 94, promulgated under the Revenue Act of 1936 (Appendix, *infra*, p. 21).

In that connection it should be noted that the court also erroneously stated in its opinion that (R. 49): "The Government freely conceded that unless the forgiveness of indebtedness in each of these instances was based upon a consideration, it would amount to a gift, and gifts are not taxable as income to the donee." No such concession was made on brief or otherwise. However, the court denied a motion to delete the statement from the opinion. (R. 51-52.)

is the ultimate factor to be ascertained, since an intention to make a gift is at least necessary, if not itself wholly sufficient, to differentiate a gift from taxable income under Section 22. *Bogardus* v. *Commissioner*, 302 U. S. 34; see also, *Helvering* v. *National Grocery Company*, 304 U. S. 282, 289, n. 5. In that light, "consideration," although relevant, is not controlling (*Sportwear Hosiery Mills* v. *Commissioner*, 129 F. (2d) 376, 382 (C. C. A. 3)), and the voluntary character of the payment does not of itself, therefore, constitute the forgiveness a gift. Cf. *Old Colony Trust Company* v. *Commissioner*, 279 U. S. 716.[11] And on the other hand a payment made in the context of commercial dealing, and in anticipation of business benefit, although perhaps not sufficient to constitute "consideration" in the contractual sense lacks the donative intention which a gift requires. *Haden Co.* v. *Commissioner*, 118 F. (2d) 285 (C. C. A. 5), certiorari denied, 314 U. S. 622, *Sportwear Hosiery Mills* v. *Commissioner, supra.*

Since the court below predicated its decision exclusively on a finding of no "consideration" it did not find it necessary to ascertain what, in fact, were

[11] See also, *Sportwear Hosiery Mills* v. *Commissioner, supra; Fitch* v. *Helvering*, 70 F. (2d) 583, 585 (C. C. A. 8); *Noel* v. *Parrott*, 15 F. (2d) 669, 671 (C. C. A. 4); *Weagant* v. *Bowers*, 57 F. (2d) 679 (C. C. A. 2); *Fisher* v. *Commissioner*, 59 F. (2d) 192 (C. C. A. 2); *Bass* v. *Hawley*, 62 F. (2d) 721 (C. C. A. 5).

the creditors' intentions in forgiving the debts here. This question, *i. e.*, whether the payments were intended as a gift (as distinguished from whether or not they resulted in a gift) is a question of fact. Cf. *Bogardus* v. *Commissioner, supra.* The record in this case discloses that the reduction of rent arrearages was first suggested by the taxpayer, who had been a tenant of the lessor for a number of years, in the course of negotiating for a new lease at a reduced rental, and that at that time the lessor intimated that an adjustment could be reached (R. 13, 16). Subsequent discussions of the problem pivoted on the question of how much of the arrearages the debtor would pay (R. 13–14). Similarly, the cancellation of interest accruing after January 1, 1932, was procured in the ordinary course of business; the president of the taxpayer suggested to its creditors that the taxpayer was unable to charge interest on its outstanding accounts, that the creditors were forgiving interest requirements for others in the industry, and that his firm wished a similar adjustment (R. 14–16). The interest charges after January 1, 1932, were cancelled, and those arising before that date were to be paid (R. 14). On this record the Board of Tax Appeals found as a fact that the cancellations were effected for business reasons and that there was no intention to make a gift (R. 42). This inference of fact, thus supported by substantial evi-

dence, is conclusive. *Wilmington Trust Co.* v. *Helvering*, 316 U. S. 164, 168.[12]

The cancellations of indebtedness in this case, negotiated as normal arms-length business transactions, and made in anticipation of commercial benefit (cf. *Haden Co.* v. *Commissioner*, 118 F. (2d) 285 (C. C. A. 5), *Sportwear Hosiery Mills* v. *Commissioner*, 127 F. (2d) 376, 382) were certainly no more acts of "spontaneous generosity" (cf. *Bogardus* v. *Commissioner, supra*) than was the award of extra compensation in *Old Colony Trust Company* v. *Commissioner, supra*. Like that award, they were properly taxable as income to the recipient. The court below therefore erred in concluding that they were gifts exempted from taxation by Section 22 (b) (3).

II

THE INCOME RESULTING FROM THE CANCELLATION OF INDEBTEDNESS WAS PROPERTY TAXABLE AS INCOME FOR THE YEAR 1937

Since the gains here realized were taxable income, there remains to be considered only whether

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[12] Since the presumption of correctness which attaches to the Commissioner's determination places the burden of proof on the taxpayer [*Burnet* v. *Houston*, 283 U. S. 223, 227-228; *Welch* v. *Helvering*, 290 U. S. 111, 115; *Helvering* v. *Taylor*, 293 U. S. 507, 514], the propriety of the Board's conclusion is in this case emphasized by the taxpayer's failure to introduce any evidence to show a donative intent (R. 42).

they were properly taxed as income for the year 1937, a question which the court below did not decide. The Board of Tax Appeals found as a fact that the debts were forgiven in 1937 (R. 40). The record discloses that, although the taxpayer's testimony supports the contention that the creditors agreed to cancel the rent and interest arrearages in 1934 and 1936 respectively, all the other evidence substantiates the Board's finding that the cancellations actually occurred in 1937. And the taxpayer's testimony in this matter was inconsistent with its own conduct.[13] Since "it is the function of the Board, not the Circuit Court of Appeals, to weigh the evidence, to draw inferences from the facts, and to choose between conflicting inferences", and since "the court may not substitute its view of the facts for that of the Board", the conclusion that the cancellations occurred in 1937, supported as it is by substantial evidence, cannot now be upset. *Wilmington Trust Co.* v. *Helvering*, 316 U. S. 164, 168; *Helvering* v. *Lazarus & Co.*, 308 U. S. 252; *Helvering* v. *Kehoe*, 309 U. S. 277.

The taxpayer contended below that the gain thus realized should not be included in its 1937

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[13] For example, although the taxpayer's president testified to the effect that he understood the interest arrearages to have been cancelled in 1936, the taxpayer's returns for that year disclose that items reflecting the very interest charges claimed to have been cancelled were deducted (R. 41).

return because it has offered to pay additional taxes for 1934 and 1936, measured upon the assumption that the rent and interest were cancelled in those years respectively, and that under Section 3801 of the Internal Revenue Code,[14] the Commissioner is authorized to make such adjustments respecting 1934 and 1936. The whole question, however, is whether the income was realized in 1934 and 1936 or in 1937. To invoke Section 3801, it would be necessary to assume that the items here in question represented income in 1934 and 1936 and were improperly omitted from the taxpayer's returns in those years.[15] The Board of Tax Appeals, however, found as a fact that the cancellations were income in 1937, not in 1934 or 1936. Hence, the remedy afforded by Section 3801 cannot possibly be available here.[16] Indeed, the argument based on that section is wholly irrelevant, because if the income was in fact realized in 1934 and 1936 (a necessary condition for invoking the section) it would not be taxable in 1937 and the suggested adjustments would not be required.

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[14] See Appendix, *infra*, pp. 19–21.

[15] It is not disputed that the deductions for rent and interest were properly taken for the years in which accrued.

[16] It is therefore unnecessary to do more than point out that for other reasons also, the taxpayer's contention misconceives the scope of Section 3801. Even if the items here involved were properly taxable in 1934 and 1936, the remedy afforded by that section does not extend to adjustments of the kind here urged. See Maguire, Surrey, and Traynor, *Section 820 of the Revenue Act of 1938*, 48 Yale L. J. 719.

CONCLUSION

The cancellations of indebtedness for rent and interest were properly taxed as income to the taxpayer for 1937, and the court below erred in failing to sustain the determination of the Board of Tax Appeals. The judgment of the court below should be reversed.

Respectfully submitted,

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NOVEMBER, 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:

* * * * *

(3) *Gifts, Bequests, and Devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income); * * *

* * * * *

Internal Revenue Code:

SEC. 3801. MITIGATION OF EFFECT OF LIMITATION AND OTHER PROVISIONS IN INCOME TAX CASES.

(a) *Definitions.*—For the purpose of this section—

(1) *Determination.*—The term "determination under the income tax laws" means—

(A) A closing agreement made under section 3760;

(B) A decision by the Board of Tax Appeals or a judgment, decree, or other order by any court of competent jurisdiction, which has become final; or

(C) A final disposition by the Commissioner of a claim for refund. For the purposes of this section a claim for refund shall be deemed finally disposed of by the Commissioner—

(i) as to items with respect to which the claim was allowed, upon the date of allowance of refund or credit or upon the date of mailing notice of disallowance (by reason of offsetting items) of the claim for refund, and

(ii) as to items with respect to which the claim was disallowed, in whole or in part, or as to items applied by the Commissioner in reduction of the refund or credit, upon expiration of the time for instituting suit with respect thereto (unless suit is instituted prior to the expiration of such time).

Such term shall not include any such agreement made, or decision, judgment, decree, or order which became final, or claim for refund finally disposed of, prior to August 27, 1938.

* * * * *

(b) *Circumstances of Adjustment.*—When a determination under the income tax laws—

(1) Requires the inclusion in gross income of an item which was erroneously included in the gross income of the taxpayer for another taxable year or in the gross income of a related taxpayer; or

(2) Allows a deduction or credit which was erroneously allowed to the taxpayer for another taxable year or to a related taxpayer; or

(3) Requires the exclusion from gross income of an item with respect to which tax was paid and which was erroneously excluded or omitted from the gross income of the taxpayer for another taxable year or from the gross income of a related taxpayer; or

(U. S. C., Title 26, Sec. 3801)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 22 (a)–14. *Cancellation of indebtedness.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22 (a)–18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. * * *

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FILE COPY

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BRIEF IN OPPOSITION TO PETITION FOR CERTIORARI

May It Please the Court:

It is submitted the writ should be denied because:

(1) The forgiveness of debt was a gift and gifts are expressly excluded from income by the Statute quoted on page 11 of the petition for the writ.

(2) If it was not a gift there was no legal forgiveness of debt.

(3) Even if not a gift, no question is presented on this record whether it was income in 1937 (the only year involved here) because the subsidiary findings of fact compel the conclusion that it was forgiven prior to 1937.

(4) There is no conflict in the decisions of the Circuit Court of Appeals.

ARGUMENT FOR EACH OF THE ABOVE POINTS

Point I.

Unquestionably the forgiveness was without consideration and it is apparently so conceded on page 7 of the petition. (The Board did not find as a fact that the forgiveness was not a gift. It merely stated this in its opinion as a pure conclusion of law from the facts found.)

The Horn book definition of a gift is thus stated in Paul's Law of Federal Income Tax (Vol. 1, sec. 6.05, page 151):

> "A gift has been defined as a voluntary transfer of property by one to another, without any consideration or compensation therefor."

See also *Blair* v. *Rosseter*, 33 F. (2d) 286 (C.C.A. 9th), Such is also the definition in New York where part of the interest was forgiven. See *Gray* v. *Barton*, 55 N. Y. 68, quoted in *Daly*, 3 B.T.A. 1042, 1044. Such is also the definition in Illinois where the balance was forgiven. Berbacker's Estate, 277 Ill. App. 201. The law of the state where the transaction took place supplies the definition. (*Erie Railroad* v. *Tompkins*, 304 U. S. 64). Right in point on the rent item is *Levy* v. *Greenberg*, 261 Ill. App. 541.

In the law of gift donative intent is simply intent to pass title to the donee without consideration and nothing more. Motives and reasons prompting the gift are immaterial. Moore's Estate, 237 Ill. App. 190. No doubt many donors of the thousands of wedding presents given Mar-

shall Goering's bride hoped for some benefit as do many donors of campaign contributions but they are nonetheless gifts.

Income Tax Regulations 45, 62, 65, 69, 74 and 77 all provided as follows:

> "* * * If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. * * *" (See Art. 64 of Reg. 77, p. 20.)

The regulations promulgated under the gift tax sections of the Revenue Code have always provided and now provide:

> "Thus, for example, a taxable transfer may be effected by the declaration of a trust, the forgiveness of a debt * * *" (Art. 2, Reg. 79.)

During the time the foregoing income tax regulations were in force Congress many times reenacted the sections of the Revenue Act here involved in identical language, without change thus bringing in operation the rule of legislative approval. *Helvering* v. *Winmill*, 305 U. S. 79, 83. Also this provision of the regulations was quoted and judicially approved in 1936 in *Gibson* v. *Commissioner*, 83 F. (2d) 869 (C.C.A. 3rd), and never disapproved.

The regulation quoted on page 11 of the petition herein does not declare otherwise. None of the examples therein given touch the case at bar. Further, none of them are really cases of forgiveness of debt.

Point II.

If the transaction was not a gift no legal forgiveness of indebtedness took place and hence no question of income arises. There are only two ways known to the law by which legal title to personal property can possibly be transferred in a situation such as here presented. One is by gift. The other is by contract based on a valuable consideration. The last is excluded by the facts found. An examination of all court income tax cases holding no gift took place will disclose they find a transfer based on valuable considerations.

As said in 33 Harvard Law Review at page 691:

> "A gratuitous parol forgiveness of a chose in action is not valid."

In all the cases where the point has arisen the debtors had to sustain it as a gift and failing this it was held no forgiveness took place. *Levy* v. *Greenberg*, 261 Ill. App. 541. *United States* v. *Bostwick*, 94 U. S. 53. See cases collected in Gifts, 24 Am. Jurisprudence, Secs. 11 and 12; also sec. 76, page 770. Also Restatement of Contracts, Sec. 76 (a), pages 83, 85. *Gleason* v. *McDonald*, 103 F. (2d) 837, 838, 839 (C.C.A. 6th).

Point III.

The Subsidiary Findings Show the Forgiveness Took Place Prior to 1937.

The only year here involved is 1937. If the forgiveness took place prior to that year it could not be 1937 income.

The ultimate finding of the Board is that it took place in 1937 but this cannot stand because it is clearly contra-

dicted by the subsidiary and special facts found by the Board.

In *United States* v. *Esnault-Pelterie*, 303 U. S. ....., it is said at page 31:

> "We may, of course, inquire whether the subordinate or circumstantial findings made by the court below necessarily override its ultimate findings of fact and show that the judgment in point of law is not sustainable."

In the same case on an earlier review (229 U. S. at p. 206) it was said:

> "The special findings may not be aided by statements in the conclusions of law or the opinion of the court."

The findings, with regard to the interest, are specific and unquestionably show the interest was forgiven in 1936. They are as follows (R. 39):

> "The petitioner, in November, 1936, owed several creditors for merchandise which they had furnished the petitioner over a period of prior years. The petitioner had been a good customer of these creditors for many years. It had given its interest-bearing notes for the amount which it owed to each creditor. It went to three of these creditors in November, 1936 and asked for cancellation of interest on the notes on the ground that the creditors had made a similar arrangement with their other customers. Three creditors agreed that they would cancel all interest accruing after January 1, 1932."

If the finding may be aided by resort to the uncontradicted evidence on which it is based, the evidence shows the same thing (R. 13 to 15).

The rent was also forgiven prior to 1936.

Point IV.

No Conflict Exists.

The case of *Hadden Co.* v. *Commissioner*, 118 F. (2d) 285, is not in conflict with the case at bar. An examination of the Board's opinion discloses the creditor who forgave the debt was liable for the debtor's obligations and forgave the debt so as not to have to pay them. This release was valuable consideration to the creditor and prevented the forgiveness being a gift. Also it had deducted the items in prior years but had not, as here, offered to pay the tax saved.

Likewise, all the court cases cited in the petition and in the Board's opinion are distinguishable. In *Jane Holding Co.*, 109 F. (2d) 933, there was no forgiveness for the court held, at p. 938, "that it was upon consideration and not gratuitous." *United States* v. *Little War Creek Coal Co.*, 104 F. (2d) 483, involved a compromise contract based on valuable consideration and in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, there was no forgiveness of anything but a sale and repurchase of bonds on the open market. In *Fitch*, 70 F. (2d) 583, a dividend was distributed to a controlling stockholder.

Petitioner refers to an alleged statement in *Sportwear Hosiery Mills* v. *Commissioner*, 129 F. (2d) 376 (note 29 at page 328) that the case at bar goes beyond the established law. We do not so read it. It quotes the statement that if there was no consideration the intent to give necessarily followed and adds: "If this language means that in every instance where a payment is made without consideration the conclusion necessarily follows that a gift has been made, it goes considerably beyond what was previously thought to be the law."

Of course the statement means no such thing. The court knew if a racketeer or highwayman exacted a payment absence of consideration did not make it a gift.

Cases in accord with the result reached in the case at bar are *Burnet* v. *Campbell Co.*, 50 F. (2d) 487, 488 (App. D. C.) and *Dallas Transfer Co.* v. *Commissioner*, 70 F. (2d) 95, 96 (C.C.A. 5th), which hold forgiveness of indebtedness not taxable income and respondent will seek to sustain the decision on this ground also should the writ be granted. The last cited case indicates the *Hadden* case went on the ground taxpayer had deducted the items in prior years but had not, as here, offered to pay the amount saved.

* * *

A final word as to the tax benefit from deducting the interest and rent in earlier years. Taxation for this reason is on a principle akin to estoppel. That cannot be invoked here, because it was stipulated respondent offered to pay petitioner all the tax it saved by these deductions and respondent rejected the offer (R. 19). Also, even in cases where it could be invoked, it should only serve to make whole the loss and not to impose a penalty, *i.e.*, be confined to the tax benefit.

For the foregoing reasons the writ should be denied.

All of which is respectfully submitted,

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IN THE

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

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BRIEF FOR THE RESPONDENT.

May It Please the Court:

A statement of the opinions below, jurisdiction and Statute and regulations involved is contained in petitioner's brief and not repeated here.

Questions Presented.

This case presents the following questions. An answer to any one favorably to respondent will affirm the judgment below. (Except 5, which will affirm it in part.)

1. Was the forgiveness of interest and rent a gift within section 22 (b) (3) of the Internal Revenue Code? (Quoted on page 19 of petitioner's brief.)

2. If it was not a gift was there any forgiveness of the debt?

3. Did Congress, by section 22 (a) of the Internal Revenue Code intend to include forgiveness of debt in taxable income?

4. Was the forgiveness of rent and interest, if not a gift, a mere diminution of loss, being a reduction in the purchase price of property and thus not income under section 22 (a)?

5. Do the subsidiary findings of the Board as to the interest show it was forgiven in 1936 and as to rent, show it was forgiven in 1394 and thus override its ultimate finding that it was forgiven in 1937?

STATEMENT.

The statement of the case on pages 2 to 5 of petitioner's brief is accepted.

Respondent argues the case from the standpoint of the rules announced by this court that a decision below may be affirmed on any ground appearing in the record, which shows it should be affirmed, although not considered by the court below. *Bondholders Committee* v. *Commissioner*, 315 U. S. 189, 192.

Foreword.

On the subject cancellation of debt the decisions of the lower courts are in great confusion. (See statements to

this effect in articles cited in note 2 on page 8 of petitioner's brief.)

In their article in the Columbia Law Review, cited in note 2 on page 8 of petitioner's brief, Mr. Sugarman and Professor Warren say: "The developments in the courts and legislature have added confusion and chaos in a field of law which for many years had been in need of clarification." Note also statements to the same effect in the other articles cited.

The question is of vital importance to thousands of struggling debtors and to thousands whose debts were forgiven or partially forgiven, during the depression. As a result of the Federal Home Owners Loan Act and the various Farm Loan Acts, tens of thousands of mortgagors had their mortgage debts partially cancelled. Debts of thousands of others were wholly or partially forgiven apart from these Acts. Congress is now seriously considering the Ruml plan, which proposes the forgiveness of one year's taxes.

If one today owed $1,000,000 and depended on future earnings to pay it he could probably never pay the debt. For one reason, because the federal tax on $1,000,000 is $899,500. If he lives in many states he would have a state income tax. If a resident of California, the two taxes total over $1,000,000.

In his message vetoing the Walter-Logan bill the President referred to a tribunal "which looks forward to results rather than backward to precedent."

Looking forward, it is not rash to say there will some day be another great depression in this country. A decision, such as petitioner here seeks, will either loom as a plague to harassed debtors or be set aside by Congress.

The history of decisions on the forgiveness of debt may be briefly summarized as follows:

In earlier decisions the Board and the courts held generally that forgiveness of indebtedness did not result in income. A few are *Meyer Jewelry Co.*, 3 B. T. A. 1319; *Eastside Mfg. Co.*, 18 B. T. A. 461; *Progress Paper Co.*, 20 B. T. A. 234. A number of cases are collected in *Towers & Sullivan Mfg. Co.*, 25 B. T. A. 922 at page 924, including *Commissioner* v. *Simmons Gin. Co.*, 42 F. (2d) 327 (C. C. A. 10th) and *Burnet* v. *Campbell*, 50 F. (2d) 487 (App. D. C.). See especially *Dallas Transfer Co.* v. *Commissioner*, 70 F. (2d) 95 (C. C. A. 5th). The Board in its opinion in that case pointed out that after the forgiveness the taxpayer was solvent. See 27 B. T. A. 651 at page 657. This doctrine was departed from due to a misunderstanding of the decision of this court in the *Kirby Lumber Co.* case and what is believed to be an unwarranted extension of that decision by the Board. (Note comment on *Kirby* case in 53 Harvard Law Review, 977.)

This court's decisions in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, and *Helvering* v. *American Chicle Co.*, 291 U. S. 426 (both set aside by section 114 of the Revenue Act of 1942) were made on a very narrow state of facts (to which they should be confined) and did not warrant the broad implications given them by lower courts. The following were the facts stated in *United States* v. *Kirby Lumber Co.*, 284 U. S. at page 2:

> "In July, 1923, the plaintiff, Kirby Lumber Company, issued its own bonds for $12,126,800 for which it received their par value. Later, *in the same year*, it purchased in the open market some of the same bonds at less than par, the difference in price being $137,521.80. The question is whether this difference is taxable gain or income of the plaintiff for the year 1923."

Of course, the court held it was income. It was a clear profit from dealing in property. Taxpayer actually received the profit in cash in the same year it bought and sold the property and the Treasury regulations in force for years expressly covered the situation. In the case at bar taxpayer received no cash or anything of exchangeable value and such Treasury regulations as there have ever been, referring to the situation, favor taxpayer. Also the bonds in the *Kirby* case were a mortgage on the property which was freed therefrom. Here the debts were not a lien on property.

The *American Chicle Co.* case was a case of bonds bought for less than the price for which they were issued. However, this court cautiously said in its opinion (291 U. S. at page 428):

> "The meagre stipulated facts present only a narrow point to which our decision must be limited."

SUMMARY OF ARGUMENT.

When Congress used the word "gift" in section 22 (b) (3) of the Revenue Act of 1936 it had a well settled judicial meaning uniform for over a hundred years. Congress is presumed to have used it in this meaning. *United States* v. *Merriam*, 263 U. S. 187. The judicial definition of "gift" is the same as that given by Blackstone and Kent and the dictionary. It is:

> "A voluntary transfer of property by one to another, without any consideration or compensation therefor." (Law of Federal Income Taxation, Paul & Mertens, Vol. 1, sec. 6.05, page 151 and cases cited at pages 12 to 14 hereof.)

It is not disputed in petitioner's brief that the forgiveness in the case at bar was voluntary and without con-

sideration. Hence it falls squarely within the definition of "gift".

Petitions seeks to have this court add to the definition a hazy and nebulous requirement which he calls "donative intent." If he succeeds it will backfire on him in the gift tax cases. Donative intent is merely another way of saying that the transfer must be voluntary and with intent to vest the subject of the gift in the donee and that there must be no consideration. An analysis of the cases using the term will reveal they either turned on the question whether there had been a consfructive delivery (and hence intent to transfer the property) or the transfer was by a corporation to one of its officers and on its face might have been compensation for services. In other words, was there consideration? Hence it was there necessary to decide whether it was intended as compensation or as a gift. Neither of these situations is now at bar. None of the elements of the above quoted definition of gift are disputed by petitioner's brief to exist here.

Also, for sixteen years, during which Congress repeatedly reenacted in identical terms the Statute here involved, the treasury regulations contained the regulation quoted by the court below (R. 49). The numerous reenactments of revenue acts while it was extant made it part of the Statute (see cases collected on page 11 hereof). Of course we would not make this point if any contrary regulation had ever been promulgated but none has. The regulation quoted on page 21 of petitioner's brief (it was not promulgated under the section of the Statute dealing with gifts) merely states cancellation of debt "*may*" result in the realization of income. "If for example" and it then gives three examples two of which are not cases of the forgiveness of debt but (1) of cancellation of debt as com-

pensation for services; (2) Income from sale and purchase of property, which two it says are income, and (3) a case of a shareholder's capital contribution, such as *Carroll McCreary Co.*, 124 F. (2d) 303 (C. C. A. 2nd), which it says is not income.

Omitted in petitioner's brief is the following statement in the regulation:

> "Income is not realized by a taxpayer by virtue of the discharge of his indebtedness as a result of an adjudication in bankruptcy, or by virtue of a composition agreement among his creditors, *if immediately thereafter taxpayer's liabilities exceed the value of his assets.*" (Italics Ours.)

It is submitted that the italicized portion of the regulation is absurd. The reason one goes through bankruptcy or makes a composition with creditors and the purpose of the bankruptcy law is to create solvency and if a bankrupt has a job or a penny he is always solvent after his discharge. Also, the only reason a creditor forgives a debt is to make the debtor solvent, otherwise he would be merely making a gift to his fellow creditors.

To say that a discharged bankrupt, made solvent by bankruptcy, has realized income from his discharge requires merely statement to disclose the absurdity of the principle petitioner would have this court lay down and the reasoning on which his argument rests.

However, if there was no "gift" in this case then no debt was forgiven and there can be no question of income. (See page 19 hereof.) All the cases cited by petitioner find a transfer of property based on a valuable consideration and thus outside the definition of "gift". So, if petitioner did prevail on the first ground respondent should prevail on this.

So far as section 22 (a) of the Revenue Act applies, here, it has been the same since income tax laws were enacted. It has been repeatedly construed by this court and Congress has repeatedly reenacted it between such constructions. The construction of the word "income" by this court was, by reenactment after these decisions, imported by Congress into the Statute. *Hecht* v. *Malley*, 265 U. S. 144, 153; *Burnet* v. *Harmel*, 287 U. S. 103, 108. In the decisions thus adopted by Congress this court defined income as "something of exchangeable value" and "a gain derived from capital, from labor or from both combined."[1] The regulations (Art. 22 (a)-1, Reg. 94) repeat and for years have repeated this definition. The forgiveness of debt in the case at bar was not derived from capital or labor nor was it anything of exchangeable value.

The forgiveness of the rent was a mere reduction in the purchase price of property which had depreciated in value below the amount agreed to be paid for it, due to the depression. It has been uniformly held such situation does not give rise to income (see page 20 hereof). Respondent never received anything for the interest.

No point can be made by petitioner of the fact that respondent deducted the rent and interest in prior years because it was stipulated respondent offered to pay the tax saved by these deductions but petitioner rejected the offer (R. 19). In this respect the case at bar differs from any in the books. Also section 3801 was designed to prevent the pyramiding of tax in one year due to prior year deductions, by making payable only the amount saved by such deductions. (See page 26 hereof.)

[1] **Strattons Independence v. Howbert**, 231 U. S. 399; **Doyle v. Mitchell Brothers**, 247 U. S. 179, and many other cases. See especially **Bowers v. Kerbaugh Empire Co.**, 271 U. S. 170.

Finally, the subsidiary finding of the Board concerning the interest item overrides its ultimate finding because it shows the interest was forgiven prior to the year before the court and hence it could not be income in this year (See page 23 hereof). They also show the rent was forgiven "in April, 1934" (R. 38).

In *Burnet* v. *Sanford & Brooks*, 282 U. S. 359, at page 364 (cited on page 11 of petitioner's brief), this court distinguished *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 170, by stating: Taxpayer "had neither made a profit on the transaction nor received any money or property which could be made subject to tax."

That is the situation at bar.

I.

The Forgiveness of Debt was a Gift Within the Meaning of Section 22 (b) (3) of the Internal Revenue Code.

Section 22 (b) of the I. R. C. reads:

> "(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this title:
>
> "(3) Gifts, Bequests, and Devices.—The value of property acquired by gift * * *"

Article 23(b)(3)-1 of Regulation 94, promulgated under the Revenue Act of 1936, like all other regulations under this section past and present, is the only regulation under this section and merely states:

> "Property received as a gift * * * is exempt from income tax."

The word "gift" is a word used in the Statute. Its meaning therefore is a question of law. If there were any

doubt about the interpretation of the word it would have to be resolved in favor of the taxpayer. *Hassett* v. *Welch*, 303 U. S. 303.

In using the word "gift" Congress meant to employ it in the ordinary and well settled meaning of the term. *Woolford Realty Co.* v. *Rose*, 286 U. S. 319, 327; *Old Colony Railroad Co.* v. *Commissioner*, 284 U. S. 552, 560. And where a word has an established judicial meaning, as "gift" had, Congress is presumed to have used it in that meaning (see quotation from this court on page 10 hereof).

The applicability of the word "gift" to the transaction at bar is supported by dictionary definition, by a judicially approved treasury income tax regulation which existed unchanged for sixteen years (quoted in the opinion of the court below), by a present treasury gift tax regulation, by Congressional intent, and by the judicial definition of gift given in Blackstone and Kent and stated in innumerable and uniform decisions and as firmly established as anything can be in the law.

Webster's New International Dictionary (2d Ed.), defines a gift as "anything voluntarily transferred by one person to another without compensation." So do Blackstone and Kent, uniform Court decisions and state Codes.

Treasury regulations 45, promulgated under the 1918 Act; Regulations 62, under the 1921 Act; Regulations 65, under the 1924 Act; Regulations 69, under the 1926 Act; Regulations 74 under the 1928 Act and Regulations 77 under the 1932 Act, all contained the following, quoted by the court below (R. 49):

> "If, however, a creditor merely desires to benefit a debtor and without any consideration therefor can-

cels the debt, the amount of the debt is a gift from the creditor to the debtor, and need not be included in the latter's gross income."

Since the promulgation of this regulation under the 1918 Act, Congress enacted five revenue acts and left the applicable Statute unchanged and the regulation was issued in identical terms under each of these revenue acts thereby bringing in operation the rule of legislative approval. *Brewster* v. *Gage*, 280 U. S. 327, 337; *Poe* v. *Seaborn*, 282 U. S. 101, 118; *Burnet* v. *Thompson Oil & Gas Co.*, 283 U. S. 301, 307; *McLaughlin* v. *Hershey Chocolate Co.*, 283 U. S. 488, 492; *United States* v. *Kirby Lumber Co.*, 284 U. S. 113; *Old Colony R. R. Co.* v. *Commissioner*, 284 U. S. 552, 557; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 302, 307; *Massachusetts Mutual Life Insurance Co.* v. *United States*, 288 U. S. 269, 273; *United States* v. *Dakota, Montana Oil Co.*, 288 U. S. 459, 466; *Reinecke* v. *Smith*, 289 U. S. 172, 175; *Helvering* v. *Bliss*, 293 U. S. 144, 151; *Zellerbach Paper Co.* v. *Helvering*, 293 U. S. 172, 178, 180; *Old Mission Portland Cement Co.* v. *Helvering*, 293 U. S. 289, 293; *Hartley* v. *Commissioner*, 295 U. S. 216, 220; *McFeely* v. *Commissioner*, 296 U. S. 102, 108; *Morrisey* v. *Commissioner*, 296 U. S. 344, 355; *United States* v. *Safety Heating & Lighting Co.*, 297 U. S. 88, 95; *Lang* v. *Commissioner*, 304 U. S. 264, 270; *Helvering* v. *Winmill*, 305 U. S. 79, 83; *Morgan* v. *Commissioner*, 309 U. S. 79, 81. The Statute has never been changed. While the quoted words were not in the regulations issued under the 1934 Act, no contrary regulation has ever been promulgated and nothing published stating rescission therefrom. (The regulation quoted on page 21 of the government brief does not declare the contrary. It was not promulgated as a construction of section 22(b)(3) excluding gifts, but as a construction of 22(a). It gives three examples, two of which

are not examples of the forgiveness of debt. The third is and is declared non-taxable.

Since their promulgation, the regulations under the section of the Code imposing the Gift Tax have always stated and now state:

> "Thus for example a taxable transfer may be effected by * * * the forgiveness of a debt" (Art. 2; Reg. 79).

Article 1 of these regulations refers "to transfers of property without consideration which, in common law, are termed gifts."

Coming now to manifestations of Congressional intent the word "gift" is not defined in the Revenue Code nor in the income tax regulations, but both the reports of the House Ways & Means Committee and the Senate Finance Committee on the Revenue Act of 1932 (when the present gift tax was enacted) state:

> "The forgiveness or payment by A of B's indebtedness would constitute a gift to B." (72nd Congress, 1st Session, Senate Report No. 665, page 39; House Report No. 708, page 28.) (C. B. 1939-1, part 2, pages 477, 524.)

The above quoted dictionary definition of "gift" is found in 2 Blackstone 440 and 2 Kent 437. It obtains in New York where part of the interest was forgiven. See *Gray* v. *Barton*, 55 N. Y. 69 and in Illinois, where the balance of the debts were forgiven, *Berbacker's Estate*, 277 Ill. App. 201, 205, wherein the court says:

> "A gift, as defined by the authorities, is a voluntary transfer of property by one to another without any consideration or compensation therefor."

The income tax decisions in the federal courts have adopted it and defined "gift" as a "voluntary transfer of property from one to another without any consideration or compensation therefor." *Blair* v. *Rosseter*, 33 F. (2d) 286 (C. C. A. 9th); *Noel* v. *Parrott*, 15 F. (2d) 669, 671 (C. C. A. 4th). Instead as pointed out in *Bothin Real Estate Co.* v. *Commissioner*, 90 F. (2d) 91, 93, 94, state Codes enact this definition.

As the court below pointed out the transaction in the case at bar literally falls within it. Petitioner's case depends on enlarging the definition.

The court below disposed of the basis of the Tax Court's decision as follows (R. 50):

> "The Board states in its opinion: 'No evidence was introduced to show a donative intent on the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity. In none of the four instances was the forgiven a gift.'
>
> "Suppose the creditors did act for purely business reasons. As long as there was no consideration for the cancellation, the intent to give necessarily followed. Evidently the Board confused intent with motive. There is no evidence that the creditors did that which they did not intend to do. The creditors motives are immaterial. *South Dakota* v. *North Carolina*, 192 U. S. 286, 310."

Under the view of the Tax Court what is a taxpayer to do? Add technical farce to the trial by calling the creditor to ask him if he intended to do what he did? There is a firmly established presumption of law that one is presumed to intend the natural consequences of his acts. *Allen* v. *United States*, 164 U. S. 492. "Intent is the purpose to use a particular means to effect a certain result.

Motive is the reason for doing it." *Baker* v. *State*, 120 Wis. 135. "Motive is the cause inducing action. Intent involves the will." *State* v. *Logan*, 344 Mo. 351.

In the *Bogardus* case (petitioner's brief, page 13) a corporation paid money to a man who had worked for it. Obviously on this state of facts the payment might have been one of two things—a gift or compensation for services. The question necessarily was which did the payer intend it to be? In other words was there consideration? In the case at bar the facts are plain and unlike that in the *Bogardus* case give rise to no such question. It is not contended there was consideration. Either the forgiveness was a gift or no forgiveness took place. (See page 19 hereof.)

It is submitted that the motive of a gift, if it can ever be considered, can only be considered in deciding the questions (1) *whether there was a transfer;* (2) *whether it was voluntary and* (3) *whether there was no consideration for it. If these three elements are present, as in the case at bar, then a gift has been made and the motive or reason for making it is utterly immaterial.*

The government did not dispute in the court below and it does not dispute in its present brief that the forgiveness of debt was voluntary and that it was without consideration. It thus falls squarely within and meets all the requirements of the definition of gift, which is:

> "Anything voluntarily transferred by one person to another without compensation."

This would end the case except that the petitioner seeks to inject, into and add to the above uniform dictionary, judicial, text book and statutory definition of a gift (in Code states) a further, hazy and nebulous conception of

donative intent. (What does he mean by this anyway? Intent to benefit the debtor or does he inquire into motives?)

A consideration of the decisions will disclose that where courts have employed the phrase it has been either solely as another way of expressing the requirements that the transfer must be voluntary, in order to solve the question of constructive delivery or else it has been used in the cases where money was transferred to a corporation's employee and the question was solely whether the payment was intended as compensation for services or a gift (*i.e.* whether there was consideration) such as the *Borgardus* case, cited on page 13 of petitioner's brief, or the *Old Colony Trust Company* case cited on the same page, in which this court expressly pointed out there was consideration for the payment, saying (279 U. S. 716, 729, 730):

> "The taxes were paid upon a valuable consideration, namely, the services rendered by the employee and as part of the compensation therefor. We think therefore that the payment constituted income to the employee."

Had the payment there been, as here, a voluntary one and without consideration it certainly would have been a gift.

The same section of the Statute, which excludes gifts from income, also excludes legacies from income but this court has indicated a legacy is taxable income where it is compensation for services. *United States* v. *Merriam*, 263 U. S. 179, 186-7.

In that case the court also said at page 187:

> "The word 'bequest' having the judicially settled meaning which we have stated, we must presume it was used in that sense by Congress. *Kepner* v. *United States*, 195 U. S. 100, 124; *The Abbotsford*, 98 U. S. 440, 444."

Of course, the same reasoning applies to the word "gift". If "donative intent" means anything it merely means a voluntary intent to transfer property to another without consideration. Reasons for doing it are beside the point and immaterial, except as they cast light on whether there was a transfer or whether there was consideration. In *South Dakota* v. *North Carolina*, 192 U. S. 286, 310, this court said:

> "But the motive with which a gift is made, whether good or bad does not affect its validity."

In *Moores*, 3 B. T. A. 301, (in which the reason or motives of the gift was to avoid income tax), the Tax Court said at page 304:

> "In our opinion, however, the motives that impelled him to make the gift are immaterial."

As pointed out in *Moore* v. *Moore*, 237 Ill. App. 190, 194, the intent to give has been considered in gift cases only because it is involved in the question whether there has been delivery and acceptance (*i.e.*, a transfer) or whether there was consideration.

It may not be amiss to point out that the injection of a nebulous theory of donative intent into and its addition to the essentials of a gift will afford a fertile field for gift tax litigation by donors seeking to avoid a gift tax and backfire on respondent. In 51 Harvard Law Review, p. 50, Mr. Paul says: "What is controlling is the absence of obligation to make the gift; it is immaterial that the donor may receive incidental benefits."

The court below properly observed that the Board's statement "the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity" was immaterial so long as the creditors did "forgive the debts". Many gifts, such as some campaign contributions are not made for altruistic reasons. If campaign contributions, induced by a donor's hope for an appointment, are not gifts they are income to the donee. The public salary of Senators from large states will not be enough to pay the tax on them. The famous Trojan horse is the classic example of a gift not so made. Many wedding presents, including some to Marshall Goering's bride, may also be cited. If one man who hated another gave him $100,000 so he could drink himself to death it would nevertheless be a gift and subject to gift tax. The Board thus reached its legal conclusion by mistaken reasoning and confusing intent and motive. It is common knowledge that gifts result from business relationships just as they result from social relationships. (Section 23(q) of the I. R. C. allows corporations to deduct the gifts therein specified.)

The argument made by petitioner here was made and rejected in *Carroll-McCreary Co.* v. *Commissioner*, 124 F. (2d) 303 (C. C. A. 2nd) in which the court said (page 305):

> "In our opinion the phrase 'gratuitously forgives the debt' means simply that no consideration is paid by the corporation for release of the debt."

That case distinguishes *Helvering* v. *Jane Holding Corporation*, 109 F. (2d) 933, cited by petitioner, by pointing out there was consideration in that case and also shows the cases, cited at pages 10 and 11 of petitioner's brief

inapplicable. (See also pages 27 to 29 hereof for comment on those prior deduction cases.)

If pages 14 and 15 of Petitioner's brief be construed as advancing the argument that the question whether the forgiveness was a gift was a pure question of fact, such argument is unsound.

In his response to taxpayer's petition for certiorari in the *Jane Holding Co.* case (cited on page 8 of petitioner's brief) this present petitioner said (page 7 thereof):

> "Whether under the findings of circumstantial or of evidentiary facts the cancellation of the debt was gratuitous was a question on which the court might properly substitute its own judgment for that of the Board. See *Helvering* v. *Tex Penn Co.*, 300 U. S. 481, 490, 491."

The precise point was decided in *Bogardus* v. *Commissioner*, 302 U. S. 34, in which this court, at page 39 said of the question whether the transaction was a gift:

> "This, as we recently have pointed out, is a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidential or circumstantial facts. It is subject to judicial review, and, on such review, the court may substitute its judgment for that of the Board. *Helvering* v. *Tex Penn Oil Co.*, 300 U. S. 481, 491. *Helvering* v. *Rankin*, 295 U. S. 123, 131."

The following cases, among others, apply this principle: *Deputy* v. *Dupont*, 308 U. S. 488, 499; *Magruder* v. *Washington, Baltimore & Annapolis Realty Co.*, 316 U. S. 69; *Helvering* v. *Price*, 309 U. S. 409; *United States* v. *Armature Rewinding Co.*, 124 F. (2d) 589, 591 (C. C. A. 8th).

II.

If the Forgiveness Was Not a Gift Then There Was No Effective Forgiveness of Debt and Consequently There Is No Question of Income in This Case.

If these debts were legally transferred from its creditors to respondent it is axiomatic and indisputable they would have to be transferred either by gift or by contract based on valuation consideration. Otherwise they were not transferred and in such event no question of income arises and the decision below must be affirmed.

There are only two ways known to the law by which legal title to personal property can possibly be transferred in a situation such as here presented. One is by gift. The other is by contract based on a valuable consideration. The last is excluded by the facts found and there is no contention it exists. An examination of all court income tax cases, cited by petitioner, holding no gift took place will disclose they find a transfer based on valuable consideration. Hence they are not in point here.

As said in 33 Harvard Law Review at page 691:

> "A gratuitous parol forgiveness of a chose in action is not valid."

See also *Allen* v. *Witherow*, 110 U. S. 119.

In all the cases where the point has arisen the debtors had to sustain it as a gift and failing this it was held no forgiveness took place. *Levy* v. *Greenberg*, 261 Ill. App. 541, is in point on the rent item. It holds it a gift but *Pusatere* v. *Darnell*, 296 Ill. App. 525, 528 holds no gift and no transfer in analogous circumstances. See also *United States* v. *Bostwick*, 94 U. S. 53. Such cases collected in Gifts, 24 Am. Jurisprudence, Secs. 11 and 12; also sec. 76, page 770, in which creditors in situations like the one at bar promised to forgive the debts and afterwards sued for them. Also Restatement of Contracts, Sec. 76(a), pages

83, 85. *Gleason* v. *McDonald*, 103 F (2d) 837, 838, 839 (C. C. A. 6th). *Farmers Life Assoc.* v. *Caine*, 224 Ill. 599, 606. *Janci* v. *Carney*, 287 Ill. 359, 366. The Statute of Limitations on a written promise is ten years in Illinois (ch. 83, sec. 17).

There is no contention that a consideration sufficient to sustain any transfer, other than by gift, exists in this case. The Board did not meet this question. If the transfer was not a gift, there was no transfer and consequently no question of 1937 income and the decision below must be affirmed.

III.

The Forgiveness of the Rent in This Case Was a Mere Reduction in the Purchase Price of Property, or Contract Renegotiation, and Did Not Give Rise to Taxable Income.

Where property has depreciated in value and the creditor, in recognition of this reduces its purchase price, no taxable income results. *Helvering* v. *A. L. Killian Co.*, 128 F. (2d) 433 (C. C. A. 8th); *Hirsch* v. *Commissioner*, 115 F. (2d) 656 (C. C. A. 7th); *Borin Co.* v. *Commissioner*, 117 F. (2d) 917; *Hertel* v. *Huston*, 28 F. Supp. 521.

Petitioner had purchased, by a lease, property, i.e., the right to use floor space, for $15,200 a year. The court will take judicial notice of the depression and its effect on realty values. (See note in 81 L. Ed. 1103.) This shrinkage was such that in 1933, instead of being worth $15,200 this space was only worth $8,400, as shown by the rental in the new lease then made (R. 38). It had suffered this shrinkage in value in 1932 and 1933.

These facts bring squarely in operation the principle of the foregoing cases, as this court will immediately per-

ceive as soon as it reads them. See also *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 170. A somewhat analogous situation is life dividends on a life insurance policy which are treated as a reduction of cost. On this ground, also, the decision below should be affirmed.

The interest forgiveness did not result in taxable income because taxpayer never received anything of exchangeable or realizable value for this interest.

The income tax rests wholly on the theory of ability to pay and the undistributed profits tax presupposes there is income to distribute. As the court below points out (R. 50), "of course, the taxpayer never received a nickel it could have distributed as dividends."

Moreover, taxpayer never received any property or any accession to its assets on account of this interest. Nor were its assets freed of any lien. There was nothing to pay tax out of. This brings the item within the statements in *Commissioner* v. *Rail Joint Stock Co.*, 61 F. (2d) 751, (C. C. A. 2nd) at page 751, that the money sought to be included in income must have at some time added something to taxpayer's assets. And, under *Phellis* v. *United States*, 257 U. S. 156, 169, this something should be of "exchangeable value." The court said in *The Rail Joint Stock Co.* case (pages 751, 752):

> "In other words, the consideration received for the obligation evidenced by the bonds as well as the consideration paid to satisfy that obligation must be looked to in order to determine whether gain or loss is realized when the transaction is closed."

The forgiveness of debt was not income within Section 22 (a) even if it was not a gift and if the forgiveness was effected by some other legal method than gift.

When Congress enacted section 22(a) of the 1936 Act (quoted on page 19 of petitioner's brief) it did so with

the definitions of income, made by this court, in mind. Indeed, section 22(a), so far as applicable here, was a reenactment in identical terms of the same section contained in all revenue acts since 1918.

This court repeatedly and uniformly construed the definition between the dates of its various reenactments by Congress. In *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, 519, it said the word had the same meaning in the income tax acts as that given it in decisions (under the excise tax) from 1909. It reaffirmed the definition in *Eisner* v. *Macomber* and prior decisions, as it has repeatedly done, and added:

> "In determining the definition of income thus arrived at, this court has consistently refused to enter into the refinements of lexicographers or economists, and has approved, in the definitions quoted, what it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the 16th Amendment to the Constitution. (Citing cases.) Notwithstanding the full argument heard in this case and in the series of cases now under consideration we continue entirely satisfied with that definition."

Compare *DeGanay* v. *Lederer*, 250 U. S. 376, 384.

The definition was repeated in *Goodrich* v. *Edwards*, 255 U. S. 527, 535.

The definitions given the word "income" by this court are repeated in *Hirsch* v. *Commissioner*, 115 F. (2d) 656, in which forgiveness of debt was held not to result in income and it was pointed out:

> "A transaction whereby nothing of exchangeable value comes in or is received by the taxpayer, does not give rise to or create taxable income," and prior decisions of courts below are examined.

See requirement of "exchangeable value" in *United States* v. *Phellis*, 257 U. S. 156, 169.

The income tax regulations under 22(a) now and for over twenty-two years have defined income as "a gain derived from capital or labor or from both combined."

The forgiveness of debt in the case at bar was not a gain derived from labor or from capital. It was therefor not taxable under section 22(a). See *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 170. It is hardly arguable that Congress would adopt a law defining forgiveness of debt to be income or that those adopting the 16th Amendment so intended.

In *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628, government subsidies were held not income under section 22(a).

The subsidiary findings of fact made by the Board override its ultimate findings and show the interest was forgiven in 1936 and the rent in 1934.

The only year here involved is 1937. If the forgiveness took place prior to that year it could not be 1937 income and the decision below must be affirmed.

The ultimate finding of the Board is that it took place in 1937 but this cannot stand because it is clearly contradicted by the subsidiary, circumstantial and special facts found by the Board.

In *United States* v. *Esnault-Pelterie*, 303 U. S. 26, it is said at page 31:

> "We may, of course, inquire whether the subordinate or circumstantial findings made by the court below necessarily override its ultimate findings of fact

and show that the judgment in point of law is not sustainable."

In the same case on an earlier review (229 U. S. at page 206) it was said:

> "The special findings may not be aided by statements in the conclusions of law or the opinion of the court."

See also statement of this court in the *Bogardus* case quoted at page 18 hereof.

The findings, with regard to the interest, are specific and unquestionably show the interest was forgiven in 1936. They are as follows (R. 39):

> "The petitioner, in November, 1936, owed several creditors for merchandise which they had furnished the petitioner over a period of prior years. The petitioner had been a good customer of these creditors for many years. It had given its interest-bearing notes for the amount which it owed to each creditor. It went to three of these creditors in November, 1936 and asked for cancellation of interest on the notes on the ground that the creditors had made a similar arrangement with their other customers. Three creditors agreed that they would cancel all interest accruing after January 1, 1932."

If the finding may be aided by resort to the only evidence on which it could be based, the evidence shows the same thing (R. 13 to 15). There is no evidence of any conversation with the creditors or any act on their part in 1937.[2]

As to the rent the Board found (R. 38):

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[2] The fact that it was entered on the taxpayer's books in 1937 shows only that and nothing more. It is not evidence that the conversations forgiving it took place in 1937. The Board expressly found they took place in prior years.

> "'The renting agent said he would make an adjustment and in April, 1934, advised the petitioner he would accept $7500 in payment of the back rent and would cancell the rest.''

This man died in July, 1934 (R. 21) so he couldn't have forgiven the rent in 1937. As pointed out in *United States* v. *Bostwich*, 94 U. S. 53, this rent reduction was not a contract. *Pusatere* v. *Darnell*, 296 Ill. App. 525, 528. See also opinion of court below (R. 49).

Petitioner is not helped by the fact respondent deducted the rent and interest in prior years because respondent offered to make him whole and he rejected this offer. Also the object and purpose of Section 3801 of the I. R. C. is applicable.

It was stipulated (R. 19) that respondent offered to pay petitioner the amount of tax it saved by the deductions in prior years and petitioner rejected the offer. He did so because he thought he could use the fact of the earlier deductions to collect much more tax from respondent than it saved by the deductions.

Taxation in a current year on account of items deducted in prior years is based on a principle akin to estoppel. There is no ground for an estoppel when one party offers to make the other whole, restore the *status quo* and save him from damage. The court below commented on "the unfairness of the government's position" (R. 50).

The argument of petitioner (Br. p. 17) that section 3801 is inapplicable rests on the misapprehension that what respondent offered to pay was the taxes for 1934 and 1936, based on the assumption that the forgiveness took place in those years. What respondent offered to pay was not this but the tax it saved by deducting the interest and rent (R. 19).

The committee reports show Congress knew a taxpayer might have saved little by deducting items in prior years but under the decisions cited on pages 10 and 11 of petitioner's brief might be taxed a large sum in a later year solely because of the earlier deductions, grossly disproportionate to the amount of tax saved by such deductions and wanted to prevent this in the future.

The Senate Finance Committee report on section 3801 states (see C. B. 1939-1, part 2, page 814):

> "This section of the bill provides an equitable solution of certain classes of income tax problems, now very numerous, which have caused much hardship to taxpayers, and great difficulty to the Commissioner, the Board of Tax Appeals and the Courts."

However, even if the case is not within paragraph (2) of section 3801 (quoted page 21 petitioner's brief) it is surely within the spirit and object of the section and since respondent, by offering to pay the tax saved by the deductions in prior years, thereby offered to do the same thing this section seeks to do, it is immaterial whether its case falls within it. The offer made it the same as if it did.

For any one of the reasons above stated and to do manifest justice the decision below should be affirmed.

All of which is respectfully submitted.

JOHN E. HUGHES,
JAMES A. O'CALLAGHAN,
Counsel for Respondent.

APPENDIX.

Page to Page Analysis of Petitioner's Argument.

The court did not err in relying on Article 64 of Regulations 77 as urged at page 5 because this regulation states what would be a gift at common law. The word "gift" was used in the statute in its judicially accepted meaning and, this being so, no regulation could give it a gloss and none has tried to. It is not claimed the quoted regulation misstates the law.

The *Maryland Casualty Co.* case, cited on page 6, is not applicable. There *the cash on which it was taxed was actually received by taxpayer.* In the second place, it never offered to pay the tax saved by charging it to reserve.

There is nothing in the Board's findings of fact which states the cancellations "were made by the creditors in anticipation of commercial benefit with no intention to make a gift". Also, good will is often, and indeed nearly always, secured by gifts and gifts are often made to secure it. As stated by Randolph Paul in 51 Harvard Law Review at p. 50: "It is irrelevant that the donor may receive incidental benefits" and "what is controlling is the absence of obligation to make the gift."

None of the cases cited on page 7 are cases of forgiveness of debt. They were cases of profit from sale and purchase of property. Besides, the 1942 Act has set them aside. It would have been better for the country had they all been decided the other way.

As to the cases cited on page 8, the Board, in its opinion in the *Hadden* case pointed out taxpayer was liable as a guarantor for the debts of the corporation whose debts it forgave. This forgiveness prevented it having to pay them and this cash saving constituted consideration sufficient to support a contract. Also, it had deducted the debt in prior years but had not, as here, offered to pay the tax saved. The decision of the same circuit in *Dallas Transfer Co.* v. *Commissioner*, 70 F. (2d) 95, 96, indicates this is the distinction. There forgiven rent was held not income. The other cases are distinguished on page 6 of our brief in opposition.

As noted in note 9 on page 11 the *State Planters Bank* decision (which the Tax Court had refused to follow) was set aside by the 1942 Act.

All the cases cited in note 6 on page 10 and on page 11 are distinguishable from that at bar on four grounds. (1) There the taxpayers actually got the cash on which they were taxed; (2) They did not offer to pay the tax saved by deductions in prior years; (3) also none of them are cases of forgiveness of debt; and (4) none involve any possible gift.

On pages 12 and 11 petitioner dodges the question of defining a "gift". Once it is defined he is out of court for the facts here literally fit the definition. Absence of consideration is controlling where the transfer is voluntary. In the *Sportswear Hosiery Mills* case taxpayer had paid the processing tax to its vendor and when the vendor's liability to pay it to the government was enjoined and the tax subsequently held unconstitutional taxpayer was probably entitled to recover it from its vendor. At the time vendees were so claiming and many vendors thought so.

As above pointed out there was consideration in the *Hadden* case in the contractual sense.

The court below did not, as alleged at the bottom of page 13 of petitioner's brief, predicate "its decision exclusively on a finding of no consideration," as a reading of its opinion will show. It said the forgiveness was voluntary and the creditors intended to forgive the debt.

The argument at the bottom of page 14 and top of page 15 that the Board's conclusion of no gift is conclusive is answered at page 18 of this brief. Furthermore, the statement confuses the opinion of the Board with its findings of fact. There is no *fact finding* that a gift was not made or of intention either.

Answering page 16 it is pointed out on page 24 hereof that the subsidiary facts found contradict the finding of ultimate fact. The conclusion that the forgiveness occurred in 1937 cannot stand where it is overridden by the findings of subsidiary and circumstantial facts.

As pointed out on page 25 hereof, the petitioner on page 17 misapprehends taxpayer's offer.

The Board repeatedly referred to the transaction as "Forgiveness of Indebtedness" (R. 38) "forgiveness of interest" (R. 39). See also Opinion, R. 40.

The word "forgiveness" including as it does the word "give," implies a gift. As said in *Roe* v. *Roe*, 98 Fla. 840:

> "A debt may be the subject of a gift by the creditor to his debtor and is generally referred to as foregiveness of debt."

IN THE

Supreme Court of the United States

OCTOBER TERM, 1942.

No. 303

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

v.

AMERICAN DENTAL COMPANY.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

SUPPLEMENT TO RESPONDENT'S BRIEF.

JOHN E. HUGHES,
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In support of the point, made on page 19 of respondent's brief, that there was no forgiveness of either rent or interest in the case at bar unless by gift we direct this court's attention to Williston on Contracts, Revised Edition, Volume 1, page 415, section 120 and to note 3 thereof, wherein many cases are collected including a decision of

this court and several decisions of the Supreme Court of Illinois.

The lease was an Illinois contract embracing Illinois real estate. Under Illinois law the promise to forgive the rent was "a mere *nudum pactum*" (*Loach* v. *Farnum*, 90 Ill. 368), and if it did not amount to a gift then there has been no valid forgiveness of rent in the case at bar. *Levy* v. *Greenberg*, 261 Ill. App. 541, and cases therein cited. The court's attention is also called to *McKenzie* v. *Harrison*, 120 N. Y. 260, 265, 266, which sustained an analogous rent reduction as a gift.

The same principle of law applies to the forgiveness of interest in the case at bar.

If the court affirms the holding of the Circuit Court of Appeals that the forgiveness was a gift that ends the case. If the court concludes otherwise then it must decide whether there was any legal forgiveness of debt and if so by what legal means. If it concludes there was no legal forgiveness of debt there in no question of income and the decision below must be affirmed.

Only if the court resolves both of the above questions against respondent will it be necessary to consider the argument, made at pages 20 to 23 of our brief, that the forgiveness of debt was not taxable income under section 22 (a) as construed in *Bowers* v. *Kerbaugh Empire Co.*, 271 U. S. 170. As stated by petitioner, on page 6 of his petition for the writ, he rests his argument in this respect on the *Kirby Lumber Co.* and *Maryland Casualty Co.* cases. The *Kirby Co.* case is discussed at pages 4 and 5 of our main brief.

The sentence in the regulation, quoted on page 21 of petitioner's brief, which reads "a taxpayer realizes income by the payment or purchase of his obligations at less than their face value" states an invalid rule unless it be qualified by article 22 (a) (18) to which it refers. Suppose one issues his $100 note to a loan shark for $90 cash and later settles it for $90. He certainly has not realized $10 income. As aptly said by the Circuit Court of Appeals for the second circuit (quoted on page 21 of our main brief) "the consideration received for the obligation evidenced by the bonds as well as the consideration paid to satisfy that obligation must be looked to in order to determine whether gain or loss is realized when the transaction is closed." The face value of the obligation may be disregarded. Here taxpayer received the right to use floor space which had depreciated in value during 1932 and 1933 so that it was worth no more than taxpayer eventually paid for it. It never received any money or property for the interest or the rent forgiven. So the items were not income.

On this question it is also necessary to consider the *Maryland Casualty Co.* case in connection with the point, made at pages 10 and 11 of petitioner's brief, concerning the effect of the deduction of the items by respondent in prior years. In addition to what is said on pages 25 to 27 of our brief we submit the following for the consideration of the court.

Petitioner candidly admits at the bottom of page 10 and top of page 11 of his brief that this court has never squarely ruled on the point. Nevertheless the decisions of the lower courts, collected in note 8 on page 10 of petitioner's brief, all proceed on the assumption that this court did so in *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 352 (cited and relied on at page 11 of petitioner's brief).

That case merely construed a special provision of the 1913 Act taxing insurance and laid down no such unjust and startling principle as some lower courts have (all without thorough examination of the case) erroneously assumed.

The government's brief on *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, states this phase of the case as follows (pp. 43, 44 thereof):

> "During the year 1913 there was a large decrease in the reserve fund for unpaid liability losses. In its original return the appellant treated the amount of the decrease as an increase in income, and the Commissioner so treated it in making the final assessment. • • • This money, it is true, had been received prior to 1913, but because it was required to be kept in reserve Congress has seen fit to enact that it should not be treated as received as taxable income. When it was released from the reserve fund it assumed, for the first time, the status of other income of the company and can fairly be said to have been for the first time received as income. Giving the most liberal construction to the action of Congress, it cannot be inferred that it ever intended any income of an insurance company should escape taxation except so long as it was required by law to be held in reserve. It is therefore submitted that when in 1913 it was no longer required for this purpose it was then, for the first time received as income and became taxable as part of the income for that year."

That the basis of this court's decision was the peculiar statutory provisions, which set up a special method for taxing insurance companies appears from the following statement in the opinion (251 U. S., at p. 352):

> "If, in this case, it were due to an overestimate of reserves for 1912 with a resulting excessive deduction for that year from gross income and if such ex-

cess was released to the general uses of the company and increased its free assets in 1913, to that extent it should very properly be treated as income in the year it became so available, *for the reason that, in that year for the first time, it became free income under the system for determining net income provided by the statute* and the fact that it came into possession of the company in an earlier year in which it could be used only in a special manner, which permitted it to become nontaxable would not prevent it being considered as received in 1913 for purposes of taxation, *within the meaning of the act.*" (Italics ours.)

From 1909 to 1913 the rate of tax on corporate income was the flat rate of 1 per cent. It made no difference in which year an item was taxable income when the tax rate was constant. The *Maryland Casualty* case was never intended to stand for the ridiculous principle that if a taxpayer saved $10,000 tax by $1,000,000 deductions from 1909 to 1913 if it chanced to recover the $1,000,000 in 1942 it would have to pay $900,000 in tax although if it had not taken the $1,000,000 in deductions from 1909 to 1913 the item would concededly not be 1942 income. There is not a line in the statute which says that deductions in an earlier year may create income in a later year and it is submitted Congress would not enact such a statute. The hardship and injustice of examples such as that above given and to which the decisions collected in note 8 on page 10 of petitioner's brief might and did lead was intended to be prevented by section 3801 (discussed at pages 25 and 26 of our main brief) which was first enacted in the Revenue Act of 1938 for this express purpose.

These cases rest on a theory akin to equitable estoppel, *i.e.*, that it is inequitable for a taxpayer to retain the benefit of the deduction and exclude the deduction (re-

covered in cash in those cases) from income in the year of recovery. This is pointed out in *E. B. Elliott Co.*, 45 B. T. A. 82, at pages 89 to 92, wherein the Board held them inapplicable if the year of deduction was still open. In the case at bar not only section 3801 but our tender of the tax saved by the deduction, either or both preclude the application of this principle which even where, if ever, applicable, produces tax distortion.

All of which is respectfully submitted,

JOHN E. HUGHES,
JAMES A. O'CALLAGHAN,
Counsel for Respondent.

SUPREME COURT OF THE UNITED STATES.

No. 303.—October Term, 1942.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* American Dental Co. | On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[March 1, 1943.]

Mr. Justice Reed delivered the opinion of the Court.

This writ of certiorari brings here for review the question of the taxability, as income, of rent and interest on accounts owed by the taxpayer which were cancelled by its creditors.

The taxpayer, a corporation, respondent here, owed certain past due bills for merchandise. This indebtedness was represented by interest bearing notes. Interest upon these notes had been accrued for the years prior to 1937 and deducted in the taxpayer's income tax returns, to the amount of $11,435.22. In November, 1936, the creditors agreed to cancel all interest accruing after January 1, 1932. The first entry on the taxpayer's books which records the cancellation appears in December, 1937, the tax year here involved, when over $16,000 was credited.

The taxpayer in December, 1933, also owed back rent amounting to $15,298.99. This back rent had been accrued as an expense. A new lease was negotiated at that time and the lessor promised to make an adjustment of the accumulated obligation. The following April the lessor advised the taxpayer that he would accept $7500 in payment of the back rent and would cancel the rest. The reduced sum was paid in February, 1937, by cash and notes which were met the same year. In 1937 the first entries were made on both the lessor's and the taxpayer's books, showing the partial forgiveness of the back rent.

The date of the book entries of the cancellations and the deduction of the interest for the whole of 1936 by the taxpayer led the Board of Tax Appeals to uphold the Commissioner's determination that the cancellation of all items of indebtedness involved here took place in 1937. This determination is accepted by us. *Wilmington Trust Co.* v. *Commissioner*, 316 U. S. 164, 168.

The taxpayer credited the total amount of the cancelled debts, $25,219.65 to earned surplus.[1] It did not return any of the sum as taxable income. No proof appears of the insolvency of the taxpayer before or after the cancellation. Its balance sheets show assets exceeding liabilities at the opening and close of 1937 with net assets greater than the asserted adjustment of income. Under these circumstances the Commissioner increased the taxpayer's reported income by $19,234.21, the sum of the items of the cancelled indebtedness which the Board of Tax Appeals found had served to offset income in like amounts in prior years. The taxpayer had accrued the rent and interest in former years. No claim for additional taxes is made by the Commissioner.

The taxpayer sought a redetermination on the ground that the cancellations were exempt gifts and that it was not enriched beyond the tax advantages gained by the deductions in former tax returns. The Board of Tax Appeals found that the cancellations were not gifts, concluded that the tax benefits in dollars obtained by the deductions of former years did not limit the 1937 tax springing from the cancellation and affirmed the Commissioner's determination of a deficiency. The Court of Appeals reversed on the ground that the cancellations constituted exempt gifts. On account of a variety of views in the circuits as to the taxability of similar adjustments of indebtedness, we granted certiorari.[2] — U. S. —.

The applicable statutory provisions are Section 22(a) and (b)(3) of the Revenue Act of 1936.[3] The general definition of

[1] There is an unexplained and immaterial variance between the sum of the items cancelled and the total credited to surplus.

[2] Dallas T. & T. Warehouse Co. *v.* Commissioner, 70 F. 2d 95; Commissioner *v.* Coastwise Transp. Corp., 71 F. 2d 104; Hirsch *v.* Commissioner, 115 F. 2d 656; Helvering *v.* A. L. Killian Co., 128 F. 2d 433; Haden Co. *v.* Commissioner, 118 F. 2d 285.

[3] 49 Stat. 1648, 1657, Sec. 22. Gross income:

"(a) *General Definition.*—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .

"(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt under this title:

. . . . . .

"(3) *Gifts, Bequests, and Devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income); . . ."

gross income has varied little in the successive revenue acts, and, from the earliest, gifts have been excluded by substantially identical statutory language. Act of October 3, 1913, 38 Stat. 166. The Treasury Department Regulations 94, relating to the Revenue Act of 1936, Art. 22(a) 14, covered cancellation of indebtedness.[4] This regulation first appeared in Regulations 86 under the 1934 Act. It marked a change in the Treasury's concept of the tax effect of debt forgiveness. The old article as it appeared in Regulations 77, relating to the 1932 act, read in part:

"If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income."[5]

The same language appeared in the former Regulations.[6]

In fields closely related to the cancellation of indebtedness which we are considering here, this Court has treated gains in net assets as income. In *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, the taxpayer purchased its own bonds at a discount. It

[4] "Art. 22(a)-14. Cancellation of indebtedness.—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22(a)-18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. Income is not realized by a taxpayer by virtue of the discharge of his indebtedness as the result of an adjudication in bankruptcy, or by virtue of a composition agreement among his creditors, if immediately thereafter the taxpayer's liabilities exceed the value of his assets."

The article relating to the exclusion of gifts from gross income is not helpful. It merely says gifts are exempt from the income tax. Art. 22(b)(3)-1.

[5] The whole article was as follows:

"Art. 64. Forgiveness of indebtedness.—The cancellation and forgiveness of indebtedness may amount to a payment of income, to a gift, or to a capital transaction, dependent upon the circumstances. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation."

[6] Regulations 74, Art. 64 (1931); Regulations 69, Art. 49 (1926); Regulations 65, Art. 49 (1922), for individuals; Regulations 62, Art. 50 (1922), for individuals; Regulations 45 (1920 ed.), Art. 51, for individuals.

When the gift tax was revived in 1932, the House Report gave as an example of a gift "the forgiveness or payment by A of B's indebtedness." H. Rep. No. 708, 72nd Cong., 1st Sess., p. 28(5).

was held taxable on the increase in net assets which resulted.[7] This holding was confirmed by *Helvering* v. *American Chicle Co.*, 291 U. S. 426. See also *Commissioner* v. *Coastwise Transp. Corp.*, 71 F. 2d 104. Forfeiture or surrender of a lease by which the lessor gains property or money makes such gain taxable. *Helvering* v. *Bruun*, 309 U. S. 461; *Hort* v. *Commissioner*, 313 U. S. 28. The narrow line between taxable bonuses and tax free gifts is illuminated by *Bogardus* v. *Commissioner*, 302 U. S. 34, on the one side and upon the other by *Noel* v. *Parrott*, 15 F. 2d 669, as approved in *Old Colony Trust Co.* v. *Commissioner*, 279 U. S. 716, 730.

Normally cancellations of indebtedness occur only when the beneficiary is insolvent or at least in financial straits. Possibly because it seems beyond the legislative purpose to exact income taxes for savings on debts, the courts have been astute to avoid taxing every balance sheet improvement brought about through a debt reduction. Where the indebtedness has represented the purchase price of property, a partial forgiveness has been treated as a readjustment of the contract rather than a gain. *Hirsch* v. *Commissioner*, 115 F. 2d 656; *Helvering* v. *A. L. Killian Co.*, 128 F. 2d 433; *Gehring Publishing Co., Inc.* v. *Commissioner*, 1 T. C. 345. Where a stockholder gratuitously forgives the corporation's debt to himself, the transaction has long been recognized by the Treasury as a contribution to the capital of the corporation. Regulations 45, Art. 51, through to Regulations 94, Art. 22(a)-14. *Commissioner* v. *Auto Strop Safety Razor Co., Inc.*, 74 F. 2d 226.[8]

The uncertainties of the effect of the remission of indebtedness on income tax brought about legislation to clarify the problems. The Chandler Bankruptcy Act of June 22, 1938, instituted adjustments deemed desirable.[9] The provision of Chapter X of the bankruptcy act relating to corporate reorganizations are typical. They declare that no income should be recognized "in respect to

[7] The fact that the purchase was made in the taxable year of issue is immaterial. Burnet v. Sanford & Brooks Co., 282 U. S. 359, 364, 365; Commissioner v. Norfolk Southern R. Co., 63 F. 2d 304.

[8] For discussions of the general problem see "The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness," 49 Yale L. J. 1153; "Cancellation of Indebtedness and Its Tax Consequences," 40 Col. L. Rev. 1326; "Discharge of Indebtedness and the Federal Income Tax," 53 Harv. L. Rev. 977.

[9] Corporate reorganizations under Chap. X or 77B, §§ 268, 270, 276(c)(3), 52 Stat. 904, 905; arrangements under Chap. XI, §§ 395, 396, 52 Stat. 915; real property arrangements under Chap. XII, §§ 520, 521, 522, 52 Stat. 929; wage earners plans under Chap. XIII, § 679, 52 Stat. 938; railroad adjustments under Chap. XV, § 735, 53 Stat. 1140.

the adjustment of the indebtedness of a debtor" under reorganization proceedings, Section 268, 52 Stat. 904, provided that the basis of the property should be reduced correspondingly as specified in Section 270 as amended July 1, 1940, 54 Stat. 709. The basis requirements do not appear throughout the sections, e. g., Chapter XV. The Revenue Act of 1939[10] amended the Internal Revenue Code, Sections 22(b) and 113(b), so as to extend similar relief to all corporate taxpayers "in an unsound financial condition."[11]

It was provided that Section 215 should not apply to any discharge of indebtedness occurring prior to the enactment of the Revenue Act of 1939. No further explanation for this limitation appears beyond the language of the House Report:

"The amendments made by section 215 of the bill are applicable only to taxable years beginning after December 31, 1938. They are not applicable to discharges of corporate indebtedness occurring prior to the date of the enactment of the bill. They are also not applicable to a discharge occurring in any taxable year beginning after December 31, 1942. They likewise do not apply to any discharge of corporate indebtedness occurring in any proceeding under section 77B, or under chapter X or XI, of the Bankruptcy Act of 1898, as amended, since such discharges are governed by other provisions of law." P. 25.

The Revenue Act of 1942, 56 Stat. —, Section 114, amended Section 22(b)(9) of the Internal Revenue Code so as to make the exclusion from gross income of income arising from discharge of indebtedness applicable generally to all corporations, whether or not financially sound.[12]

In the light of these views upon gain, profit and income, we must construe the meaning of the statutory exemption of gifts from gross income by Section 22(b)(3). The broad import of gross income in Section 22(a)[13] admonishes us to be chary of extending any words of exemption beyond their plain meaning.

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[10] 53 Stat. 875, § 215.

[11] See S. Rep. No. 648, 76th Cong., 1st Sess., p. 5; H. Rep. No. 855, 76th Cong., 1st Sess., p. 23.

[12] See S. Rep. No. 1631, 77th Cong., 2d Sess., p. 77; 26 U. S. C. § 22:

"(b) Exclusions from gross income. The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

. . . . . .

"(9) Income from discharge of indebtedness.—In the case of a corporation, the amount of any income of the taxpayer attributable to the discharge, within the taxable year, of any indebtedness of the taxpayer . . . evidenced by a security. . . . This paragraph shall not apply to any discharge occurring before the date of enactment of the Revenue Act of 1939, or in a taxable year beginning after December 31, 1945."

[13] Helvering v. Clifford, 309 U. S. 331, 334.

Cf. *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232, 235; *United States* v. *Stewart*, 311 U. S. 60, 63. Gifts, however, is a generic word of broad connotation, taking coloration from the context of the particular statute in which it may appear. Its plain meaning in its present setting denotes, it seems to us, the receipt of financial advantages gratuitously.

The release of interest or the complete satisfaction of an indebtedness by partial payment by the voluntary act of the creditor is more akin to a reduction of sale price than to financial betterment through the purchase by a debtor of its bonds in an arms-length transaction. In this view, there is no substance in the Commissioner's differentiation between a solvent or insolvent corporation or the taxation of income to the extent of assets freed from the claims of creditors by a gratuitous cancellation of indebtedness. *Lakeland Grocery Co.* v. *Commissioner*, 36 B. T. A. 289. Cf. *Madison Railways Co.* v. *Commissioner*, 36 B. T. A. 1106; *Spokane Office Supply Co.* v. *Commissioner*, Docket No. 86762, memo. op. of April 29, 1939; *Model Laundry, Inc.* v. *Commissioner*, Docket No. 93493; memo. op. of January 15, 1940. See also *Haden Co.* v. *Commissioner*, 118 F. 2d 285, which supports the Commissioner.

The Board of Tax Appeals decided that these cancellations were not gifts under Section 22(b)(3). It was said:

"No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity." 44 B. T. A. 425, 428.

With this conclusion we cannot agree. We do not feel bound by the finding of the Board because it reached its conclusions, in our opinion, upon an application of erroneous legal standards. Section 22(b)(3) exempts gifts. This does not leave The Tax Court of the United States free to determine at will or upon evidence and without judicial review the tests to be applied to facts to determine whether the result is or is not a gift. The fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute.

Affirmed.

Mr. Justice Rutledge took no part in the consideration or decision of this case.

SUPREME COURT OF THE UNITED STATES.

No. 303.—October Term, 1942.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* American Dental Co.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Seventh Circuit.

[March 1, 1943.]

Mr. Justice Frankfurter, dissenting.

When Congress wished to exempt income "attributable to the discharge . . . of any indebtedness" it did so explicitly. It defined such exemption with particularity and only to a limited extent, as illustrated by the various enactments, including § 114 of the Revenue Act of 1942, all of which appear to throw light leading away from and not towards the conclusion drawn from them by the Court. In the absence of such specific exemption of what as a practical matter may be income, determination of whether it is or is not income should be left to the tribunal whose special business it is to ascertain the controverted facts and the reasonable inferences from them. In deciding that, in the circumstances of the present case, the debt cancellations were not gifts and therefore taxable, the Board of Tax Appeals (now the Tax Court of the United States) did not invoke wrong legal standards. It knew well enough the difference between taxable income and gifts. It applied these legal concepts to its interpretation of the facts. That its judgment should not be upset is counselled by wise fiscal as well as judicial administration.

Mr. Justice Jackson joins in this dissent.